PRINCIPLES AND PRACTICE OF AUDITING

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FOREWORD

Professor B. B. Roy and Professor P. Ghosal of the City College, Calcutta, have shown me the manuscript of a book on Auditing entitled "Principles and Practice of Auditing" which they have written apparently for the use of students who take up this subject in their University Courses. The Authors have taken great pains in suitably arranging the different aspects of the subject and have given adequate number of Test questions at the end of each chapter. They have brought Auditing Principles to the notice of students in an effective manner.

All efforts which go to assist students in effectively grasping principles and practices of this subject should be welcome and I commend the publication for wider acceptance.

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Dedicated To

ANJAN AND GAUTAM

PREFACE

The Authors have much pleasure in presenting before the students, the teachers and the members of the Accounting world this humble work of theirs. They have laboured long and hard to arrange the topics in a systematic and well-knit manner. The fundamental principles of the subject have been dealt with from the practical point of view, and all possible care has been taken to assist the reader in learning them quickly as well as thoroughly.

No single text-book can cover all the essential aspects and questions of the subject it deals with, and it would be idle to expect from the contents of a book of moderate dimension answers for all of the Auditing Examinations which were held in the past and which the examinees will take in the years to come. It is also very difficult to shut out errors and omissions altogether. The best results would be obtained by the reader if he supplemented his study by referring to at least one other text-book.

Students intending to sit for a higher Accountancy Examination would amply benefit if they devoted themselves *first* to the learning of the basic principles and the exact meaning and implication of the terms and documents that are to be frequently referred to, and *then* to the study and discussion of an advanced or subtle topic. M. Com. examinees and candidates for professional or departmental examinations are on that account advised to go through the elementary and explanatory portions of the book dealt with by the Authors mainly for those that are in their undergraduate classes. A person's grasp over his subject is thorough only when his knowledge is broad based and stands on a solid groundwork. To attain this aim, one has to be punctilious

about removing all haziness as to the fundamental principles, ideas and ideals. Else,—there is reason to be afraid—the edifice though attempted to be built with a good amount of labour will have but a feeble form because of poverty at the base. Eloquence, whether of speech or of writing, springs from a good assimilation of the underlying thoughts behind the subject-matter of study.

The help extended to the Authors by their teachers, colleagues, pupils and other friends in bringing out this humble treatise is acknowledged with a deep note of gratefulness. The name of Sm. BIJAYLAKSHMI GHOSAL, B.A. deserves particular mention, as she has lent fillip and kind assistance to the Authors in the preparation of this volume.

All suggestions for improvement will be thankfully received.

Calcutta

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B. B. Roy
P. Ghosal

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CHAPTER I

DEFINITION, SCOPE AND IMPORTANCE OF AUDITING

Auditing means a thorough scrutiny of the books of accounts. The Auditor is to detect errors in the preparation of accounts and certify the correctness of the financial books. If this verification is not conducted properly, the results as shown by the accounts cannot be relied upon. The importance of doing a regular Audit is universally acknowledged today. Inaccuracy may creep into the accounts in various ways and for sundry reasons. The root principles may not be given due regard or manipulation may be done on purpose. With the Auditor rests the responsibility of detecting such irregularities.

Meaning and Subject-matter of Auditing

Accountancy is the art of recording the daily transactions in a set of financial books. Auditing, on the other hand, is the critical examination and confirmation of this record. The latter aims at finding out inaccuracies in the work of the Accountant. The entries passed by the Accountant and the Final Accounts compiled by him are to be verified by the Auditor. Through such verification the state of affairs of a concern is truly revealed. Sometimes an Auditor is requested to write up the books of accounts of his client from such records and documents as are produced before him. He may also be required to prepare the Final Accounts. Here, the Auditor plays the role of an Accountant. He will have a different and distinct assignment if he is also asked to conduct Audit on those very books of accounts. In two important English cases the Judge freed the firm of Chartered Accountants from the charge of non-detection of fraud, on the consideration that the firm was appointed as Accountants, only for the compilation and submission of Income Tax Returns, and not for conducting a Balance Sheet Audit. The cases are :

Difference between Accountancy and Auditing

(i) Apfel *v.* Annan Dexter & Co. (1926, 75 Acct. 687) ; and (ii) Leech *v.* Stokes (1937, 81 Acct. L.R. 87).

The advantages of an Audit may be summed up as follows :

Benefits of an Audit

(*a*) The true financial position of an institution is revealed.

(*b*) Accounts are kept up-to-date due to pressure of Audit, particularly when a continuous Audit is in operation.

(*c*) Errors are rectified and chances of fraud or defalcation are minimised.

(*d*) Defects and shortcomings in the Accounting methods and in internal administration are rectified.

(*e*) Audited accounts and statements are of great help, particularly for the following purposes :—

(*i*) Realisation of various kinds of claims, such as Insurance claims &c. ;

(*ii*) Assessment of Income Tax and Sales Tax ;

(*iii*) Raising of Capital *or* Floatation of Loan ;

(*iv*) Valuation of Shares ;

(*v*) Settlement of partnership affairs and disputes ;

(*vi*) Purchase or Sale of business ; and

(*vii*) Import/Export Statements.

Objects of an Audit

The objects of an Audit are twofold : (i) Detection of frauds and errors ; and (ii) Prevention of frauds and errors. Frauds, again, may be of two types : (a) misappropriation of money or goods ; and (b) falsification of accounts.

Misappropriation of Cash. Misappropriation or defalcation of cash may occur when, for instance, a cashier receives a donation of, say, Rs. 1,000 from a patron of the institution he serves, issues a receipt for the amount and removes the counterfoil from the Receipt Book. The transaction goes

unrecorded in the Cash Book and the money is pocketed by the cashier. This is a clear case of misappropriation of cash. It can be detected if the Auditor takes the trouble of *scrutinizing all the consecutive numbers of the Receipt Counterfoils.* A good remedy against cash being misappropriated is the *use of a National Cash Register* for recording all cash collections. When customers make payment, the Bills presented by the parties, showing the amount collected, come out of this modern mechanical device when a button is pressed by the cashier. All receipts of cash are recorded on a paper tape by the National Cash Register. At the close of the day, the tape and the mechanical appliance indicate the total collections made during the day This tape will be collected by the Management after verifying the total from the *National Cash Register.* Cash collections as recorded on the tape must be at the debit of the Cash Book.

Defalcation of Goods. Defalcation or misappropriation of goods, on the other hand arises in this way. The store-keeper, in collusion with the Works Manager. may sell goods surreptitiously to an outside party, the Management not knowing anything about it. Such defalcation can be detected if the Auditor carefully checked up the Purchases, Sales and Stock records. Another interesting instance of goods defalcation may be given. The management purchases Capital goods from abroad, say, for a Jute mill Company run by a Managing Agency House and pays the invoice price in full, obtaining the Shipping documents thereby. The goods are duly landed and on way to the mill a portion is sold without authorisation to an unscrupulous business man. The sale is done through the Mill Manager with the connivance of the Store-Keeper. In a case like this the Auditor is to instruct his client for ensuring due verification of the arrival of the goods at the premises of the Mill. Some responsible official from the Managing Agency House should be present to check up the goods with the relevant documents at the time of arrival.

Falsification of Accounts. Falsification of accounts arises generally through passing of false entries in respect of fictitious sales or purchases. Closing Stock may also be inflated through the inclusion of non-existent items or improper overvaluation. The motive is to declare a good

dividend resulting from an increase of profits, and to have a rise in the share price. Accounts falsification may assume other shapes too. Excessive provisions for bad and doubtful debts or charging depreciation exceeding adequacy or overstating the liabilities will also falsify the accounts. In these cases the motive is to lower the volume of profit. Unscrupulous directors of a joint stock company may be on the look-out for a fall in share price when the business position is actually sound. When the crash comes, they would increase their shareholdings.

Fraud and Internal Check

In detecting fraud where trusted and responsible officers of the concern are involved, the Auditor has to exercise considerable care and skill. To prevent there being fraud, internal check should be in operation. Internal check indicates an arrangement by which the work done by one person will be made to be checked up by another.

Audit aims at finding out errors, if any, in the accounts. Errors may be classified as shown in the diagram.

Kinds of Errors

Errors

- Clerical Errors
  - Errors of Omission
  - Errors of Commission
- Errors of Principle

Clerical error is committed through mistake of a clerk. This mistake is due to inadvertence or carelessness. A clerk may have omitted to record something which ought to have been in the account books. This is *Error of omission.* For example, if an invoice of Rs. 100 on account of credit purchase is not recorded in the Purchases Book, this will be a clear case of omission. Error of Omission may also arise through a

How Errors of Omission arise

transaction being recorded in the Journal but not recorded in the Ledger. This is omission in ledger-posting. It is also likely that an account in the ledger has been debited but there is no correspon-

ding credit to another account. Errors of omission may be detected easily where, due to the error, Trial Balance does not agree. If the error is such that it does not affect Trial Balance agreement, its detection will require careful Audit.

Errors of Commission arise where a mistake has been committed, through negligence, in the matter of recording a certain transaction. Erroneously an account may be debited instead of another when there is nothing wrong in the credit entry. If in recording a sales transaction Alexander's account is debited, where goods have actually been sold to Hamilton, this would be a case of Error of Commission. Errors of Commission may creep into the books in innumerable ways through incorrect postings, castings and calculations. To detect these errors a complete and exhaustive Audit programme has to be outlined and efficiently carried out. Compensating Error is but a form of Error of Commission. For example, if the debit side total of the Cash Book is undercast by Rs. 100 with a similar undercast on the credit side of Rs. 100, this would be a case of Compensating Error. This kind of error will not be detected at the time of drawing up the Trial Balance. The Auditor will locate such errors while *checking up casting* of the Cash Book.

How Errors of Commission arise

Errors of Principle arise wherever the principles of Accounting are disregarded. Such an error is sometimes committed intentionally to falsify the accounts with some ulterior motive. In a limited company, a Revenue Expenditure may be treated as Capital Expenditure with the result that profits are inflated. The expectation is that the price of the company's shares would go up in the market, and the Directors would dispose of a portion of their shareholdings when the shares are at a premium due to the declaration of handsome dividend. To give an instance of the above, if the Voyage Account (which is in the nature of Profit and Loss Account) of a steamship company is debited with fifty per cent. of the expenditure on coke which is incurred for the running of the vessel and the other fifty per cent. is debited to Vessel Account (a fixed asset), the profit will be inflated. The debit to Vessel Account

How Errors of Principle arise

will be interpreted as an improvement of the Asset though nothing of the sort is done. Here the error culminates in intentional manipulation of Accounts. There may also be cases of unintentional Errors of Principle due to ignorance of the Accountant. For example, while drawing up the Final Accounts, if there is underprovision for Depreciation, for Taxation or for Bad and Doubtful Debts, it will give rise to an Error of Principle that is not wilful. Such errors can be detected by the Auditor if he exhaustively checks up the Accounts with all the relevant papers and makes a thorough investigation of the nature of business before commencing his Audit.

Growing Importance of an Audit

The Auditor is at a premium today. There has been an all-round expansion of trade, industry and commerce in recent times. The past few years have in particular seen an enormous rise in the number of Joint Stock Companies. And for such concerns Audit by a qualified Auditor is compulsory under the Companies Act. His service is being increasingly sought after these days, also by organisations not under any binding to arrange an Audit. The business world has realised that a number of advantages can be derived from an efficiently conducted Audit. In many of the trading concerns, those that have invested money, generally stay away from the day-to-day administration. And such people (e.g., sleeping Partners of a firm *or* Shareholders of a limited company) have to place their reliance on the Auditor for the protection of their interests. Audit serves as a moral check on the Management when it is apt to be unscrupulous. The suggestions given by an Auditor with his expert knowledge of Accounts are often highly valued and the Professional Accountants, therefore, have an important part to play in the present day society.

QUESTIONS ON CHAPTER I

1. What do you understand by the term 'Auditing'? Examine the importance of Auditing.

2. What is meant by Auditing? Mention the objects and advantages of an Audit.

(National Diploma in Commerce, Govt. of India.)

3. Should the Accounts of every concern be subjected to a regular Audit? Why is Auditing gaining popularity even where it is not obligatory?

[*Hints* : According to the Companies Act, Audit by a duly qualified Auditor is compulsory for every Joint Stock Company. Audit is also insisted upon in schools and colleges receiving aid from the Government and in the case of Co-operative Societies registered under the Co-operative Societies Act. For other organisations it is optional. Nevertheless, the Accounts are brought under an Audit now-a days almost by every business house. There are two reasons for this : (i) to detect mistakes and frauds ; and (ii) to avoid arbitrary Income Tax assessment.]

4. (What are the main classes of errors and frauds found in auditing a firm's Accounts? Give illustrations.) Can the Auditor prevent such errors and frauds? (B. Com.)

5. Carefully distinguish between the rôle of an Accountant and that of an Auditor.

6. The proprietor of a business concern suspects defalcation of cash in respect of Cash Sales and requests you as his Auditor to devise ways and means to stop such defalcation.

[*Hints* : An efficient internal check together with the introduction of a modern office appliance known as *National Cash Register* is suggested as a remedy against defalcation of Cash collections.]

7. The Auditor of a Joint Stock Company that runs a Jute Mill is requested by the Managing Director to formulate a system for checking defalcation of goods. Outline your system.

[*Hints* : To arrest defalcation of goods a sound system of internal check regarding purchases, storage, issue of materials to Jobs and inter-departmental transfers should be in operation. No payment for goods purchased should be made unless a *Store Receipt* indicating the receipt of the goods at the Jute Mill is properly submitted to the Accounts Department after being signed by the Storekeeper and countersigned by the Mill Manager with a note that the goods were received in good condition at the Mill.]

8. Cite examples showing how the Profits of a business may be manipulated by falsification of Accounts.

[*Hints* : Through overvaluation of Closing Stock or suppression of the purchases, particularly of the last month of the

Accounting year, the Gross Profit may be inflated. Similarly by decreasing the sale or by undervaluing the Stock, Gross Profit may be decreased. From the omission of Nominal expenses, from inadequate provision for Depreciation *or* for outstanding liabilities for expenses and from the treatment of Revenue Expenditure as Capital Expenditure, an increase in the volume of Net Profit will follow. The Net Profit, on the other hand, will get decreased by over-provision for Depreciations and Doubtful Debts and by omission of income earned but not received.]

9. "An Auditor is liable for any damages sustained by a Company by reason of falsification which might have been discovered by the exercise of reasonable care and skill in the performance of the Audit." Discuss the above statement.

(Chartered Accountants)

CHAPTER II

CLASSES & TYPES OF AUDIT

Audit may broadly be divided into three classes :

Three Classes of Audit

(*a*) *Audit under Statute ;*
(*b*) *Audit of Private Firms* ; and
(*c*) *Audit of accounts of Sole Traders.*

Under the Indian Companies Act, Audit of the accounts of Limited Companies by a duly qualified Auditor is compulsory.

Audit under Statute

The manner in which the Audit is to be conducted is laid down in the said Act. Furthermore, the method of appointing the Auditor is also prescribed in the Act. The First Auditor is appointed by the Board of Directors and the subsequent Auditors are appointed by the Shareholders at the Annual General Meeting. The law aims at safeguarding the interests of the Shareholders who are in the dark as to the running of the company's business by the Directors. The Auditor is to submit Report on the Annual Accounts and is to certify that the Balance Sheet exhibits a true and fair view of the state of affairs of the Company. If he is not satisfied with the manner in which the Accounts have been drawn up, it is his duty to bring the matter to the notice of the Directors. The Directors not having agreed to redraft the Balance Sheet, the Auditor should qualify his Report to the Shareholders on the Balance Sheet. The Auditor must not be afraid of losing the favour of the Directors in so qualifying his Report

Audit of a limited company as outlined above is of great importance. It acts as a moral check on the Directors and other

Importance of Statutory Audit

managerial staff. It will also render commission of mistake and frauds on the part of employees difficult. Through such Audit, timely preparation of Accounts is ensured and the shareholders may take the prepared Accounts as correct. There is also no delay in the declaration of dividends. Statutory Audit,

furthermore, acts as a valuable guidance relating to financial and accounting matters.

Audit of Private Firms

A 'Firm' means a partnership run by several partners. The Auditor of such a firm is appointed by the partners on mutual agreement. Up to now, Audit of a firm is not obligatory as in the case of a limited company. But to avoid arbitrary assessment by the Income Tax Department, it has almost become universal to have the Partnership Accounts regularly Audited by a qualified Auditor. A firm also seeks the help of an Auditor just to enjoy all the benefits of an Audit as discussed in the foregoing chapter. The duties of such an Auditor are to be clearly laid down in the letter of Appointment issued by the firm. The Audit of accounts in a Partnership concern is of particular importance especially in the cases of retirement, death and admission of a Partner and in the case of sale of a going partnership. Audit of the accounts of a firm will also be required when Loan is obtained from a Bank or an outside party or a Sleeping partner. The difference between Statutory Audit and Partnership Audit should be carefully observed. In the case of the former, the Auditor's duties and responsibilities are determined by the Statute, whereas the duties of the Partnership Auditor are set out in the letter of appointment from the Partners. No uniform practice, or procedure will, therefore, be noticed in Partnership Audit.

Audit of Sole Traders

Here, too, as in Partnership, Audit is not compulsory. But the help of a qualified Auditor is being increasingly sought after in recent times because of the advantages of a Scientific Audit. Appointment rests on the sole proprietor who, may wish not to be harassed by taxation authorities. The nature of duty will be given in the Appointment Letter in clear and unambiguous terms. If the sole owner of a business institution dies, the executors will require Accounts that have been subjected to a regular Audit. This is for correct ascertainment of death duty and fixation of fees for Succession Certificate payable to the Government.

Audit of concerns other than a Company, a Firm or a Sole Proprietorship

Certain other classes of Audit also deserve mention. Institutions are there which are not meant for profit-earning. These institutions, such as a Club, a Hospital, a Library, a School, a College, &c., will require the service of an Auditor. Here the Auditor's duties would be guided by the rules and regulations of the particular institution. The scope of work as outlined in the Letter of appointment will also be of importance. A number of Joint Stock Companies doing public utility service come under *Special Statutes,* i.e., particular Acts passed by the Parliament. Such companies are known as Statutory Companies. For instance, the Calcutta Tramways Company, Ltd. is under the purview of the Calcutta Tramways Company Act passed by the British Parliament, the Company being incorporated in England. The Oriental Gas Company, Ltd. and The Calcutta Electric Supply Corporation, Ltd. also belong to the category of Statutory Companies. Evidently, the Audit in these cases is to be conducted on the lines as prescribed in the particular Statute under which a Company has been formed. According to the Indian Trust Act, *Trust Accounts* must be Audited by a qualified Auditor showing clearly the Trust income and disbursements. Under a trusteeship arrangement the *will* executed by a person, holding movable or immovable property, gives direction to one or more Trusted persons for acting as Executor after his death, so that the beneficiaries (Relations receiving benefit from the Trust property) are not deprived of their dues and have a fair and square deal. The Audit of Trust accounts is essential for upholding the interests of the beneficiary.

Types of Audit :—
(*a*) Continuous
(*b*) Periodical,
or Final.
or Completed.

Audit of an Institution assumes mainly two different types, viz., (i) Continuous and (ii) Completed (*or* Final *or* Periodical). Types of Audit should not be confused with classes of Audit as explained before. By Continuous Audit is meant conducting of Audit throughout the year. The Accounts are subjected to Audit as and when they are prepared. This type of Audit is very useful where business tansactions are numerous. Final *or* Periodical Audit on the other hand, is conducted only when all the Books of Accounts

have been closed at the end of the financial year and the Final Accounts have been drawn up. This type of Audit is also known as Balance Sheet Audit.

Advantages of Continuous Audit

The following are the main advantages of a continuous Audit. (a) As the Books are examined after they are written up, errors and frauds, if any, are discovered quickly. And the staff will think thrice before committing any irregularities. (b) As the Auditor will have enough time, he can check the transactions in detail. The mistakes, therefore, have greater chances of coming to light. (c) The frequent visit of the Auditor will make the Accounting staff keep their records up-to-date and this will act as a moral check. (d) The Final Accounts can be drawn up at the year-ending promptly and without loss of time.

Disadvantages of Continuous Audit

Continuous Audit is not, however, altogether free from defects. (a) *Records and figures may be altered* after Audit is over. (b) For the Auditor it is often *difficult to maintain link between present and past work.* He may lose the thread of connexion and omit Auditing certain transactions. These defects can, however, be removed if the Auditor issues instructions to the client to record all the figures in ink and not to change any audited figures without bringing it to the knowledge of the Auditor. To prevent unauthorised alteration of figures the Auditor should use 'Ticks' in *special* ink while doing continuous Audit. To guard against the thread being lost. a suitable Audit Note Book may be kept by the Auditor. In this Book he is to record the day-to-day Audit progress in detail.

Advantages and disadvantages of Periodical Audit

The main advantage of Periodical Audit is that Final Accounts are prepared and Audited within a reasonable time after the closing of the financial year. This type of Audit, it may be said, is also free from the defects of continuous Audit. To say of the disadvantages, it may be pointed out that frauds and errors are detected too late and the persons guilty of such offences may decamp before their guilt comes to light.

Continuous Audit is to be conducted throughout the year by *External Auditors,* whereas Internal Audit will be a system of examining the Accounts by the very members of the staff of the concern in such a manner that one's work will be checked up by another.

Difference between Continuous and Internal Audit

A distinction between 'Complete' Audit and 'Partial' Audit is of importance. When *all* the financial Books and Records are subjected to Audit, it is a case of 'Complete' Audit. When, on the other hand, an Audit is conducted on *some* of the Books and Records for a particular purpose, e.g., share valuation, detection of cash defalcation, &c., it is called a 'Partial' Audit.

'Complete' Audit, as opposed to 'Partial' Audit

Sometimes for a particular purpose, such as declaration of an interim dividend by a Joint Stock Company, the Auditor is invited to conduct a complete Audit on the Accounts compiled for a part of the accounting year. An arrangement like this may be called Interim Audit.

Interim Audit

QUESTIONS ON CHAPTER II

1. What are the different classes of Audit ? Explain the manner of appointment and the scope of work of the Auditor in each case.

2. Write explanatory notes on :

(a) Statutory Audit.

(b) Audit of the Accounts of a firm.

(c) Audit of the Accounts of a Sole trader.

(d) Continuous Audit.

(e) Periodical (*or* Completed *or* Final) Audit.

(f) Complete Audit.

(g) Partial Audit.

(h) Interim Audit.

(i) Audit of a non-trading concern.

(j) Audit of Trust Accounts.

(k) Audit of Public Utility Company.

(l) Internal Audit.

3. In what respects do the position and duties of an Auditor of a limited company differ from those of an Auditor of a private firm ?

(National Diploma in Commerce, Government of India.)

[*Hints* : (a) Audit in the case of a limited company is compulsory ; for a private firm this is optional.

(b) For the Company Auditor the rights and duties are defined by the Companies Act ; for the Auditor of a firm the Letter of Appointment indicates the nature of work and responsibility.

(c) The Company Auditor is for safeguarding the interests of the Shareholders who appoint him ; The Auditor of a Firm will uphold the interests of the partners who are the appointing authority

(d) The Company Auditor should be conversant with the Company Law thoroughly and examine in detail the Memorandum, the Articles, the Prospectus and other important Documents of the Company ; the Auditor of a firm has a less laborious task—he should only study the provisions of the Partnership Agreement.

(e) The status of a Company Auditor is that of an Officer of the Company ; The Auditor of a firm does not enjoy such position.

(f) The Company Auditor has to perform a comprehensive and complete Audit under the Statute ; the Auditor of a firm will do a Partial Audit or a Complete Audit depending on the terms of Appointment from the Partners.

(g) A Company Auditor must be a member of the Institute of Chartered Accountants, holding Licence of Practice from the Central Government ; for Partnership Auditor, the Partnership law does not prescribe any such qualifications.]

4. What are the duties and obligations of an Auditor with regard to Audit of (a) a firm and (b) a Company ? (B. Com.)

[See *Hints* to Q. 3.]

5. Comment on the advantages and disadvantages of a Continuous Audit with special reference to the safeguards employed by the Auditor engaged on such work.

[*Hints* : Regarding safeguards to be employed by the Auditor at the time of the completion of the day's work, the Auditor should make a note of the progress made during

the day, so that when he visits for the next time he does not miss the link and omit any portion of the work. Besides, the Auditor should see that all the entries are in ink including the *totals* ; this would render alteration of figures difficult.]

6. (a) What do you understand by a Continuous Audit ? (b) What are its advantages to (i) Shareholders (ii) Auditors ? (c) What are its disadvantages from the point of view of Auditors ? How can they be overcome ? (B. Com.)

[*Hints* : (i) The *Shareholders' advantages* from a Continuous Audit are that they may know of the true position of the Company soon after the financial closing : they also get their dividend early and can submit their Income Tax Returns in time.

(ii) The advantages of a Continuous Audit from the standpoint of the Auditor are that the Routine work of the Financial Books is almost complete before the Accounting Year is over. Furthermore, the Auditor can concentrate on the Final Accounts and certify them soon after the financial closing. Under the Companies Act it is obligatory for every Joint Stock Company to hold the Annual General Meeting of shareholders within six months from the date of financial closing and it will be a great advantage to the Company Auditor if there is a Continuous Audit in operation.]

7. (a) What do you understand by (i) 'Continuous Audit' and (ii) 'Periodical Audit' ? (b) What are their relative merits and demerits ? (c) Under what circumstances, if any, is Continuous Audit considered essential ? (M. Com.)

CHAPTER III

THE QUALIFICATIONS AND THE OFFICE OF THE AUDITOR

The Auditor has to be imbued with a strong sense of duty. He ought to be conscientious in the due discharge of the sacred task entrusted to him. A thorough knowledge as to the method of keeping the Books and the preparation of Accounts is expected of him. A strong common sense will always help him to be efficient in the due execution of his job. Patience, tactfulness, accuracy in work, and ability to prepare the Accounts under his examination by himself will be adding to the Auditor's qualifications. The Auditor must not be a mechanical checker, but should exercise his vigilance with eyes open for detection of unfair practices.

Auditor's Qualifications

In addition to the qualifications stated above, a Company Auditor should be a Chartered Accountant and has to obtain a *Licence of Practice* from the Central Government. He should be fully conversant with the Companies Act in order to be able to conduct his Statutory Audit.

Special Qualifications of a Company Auditor

The Auditor's office must be centrally located, preferably in business quarters. The office ought to be kept in a neat and tidy way so that the clients' impression is readily gained Modern office equipments, such as Telephone, Typewriter. etc., have always to be there. Means permitting, help of labour saving devices like Comptometer, Duplicating Machines, National Cash Register, Dictaphone & Ediphone, &c., should also be taken.

Auditor's Office

The Audit Assistants should be of two categories : Junior Assistants and Senior Assistants. The former will be entrusted with the task of routine checking, viz., checking of castings and postings. The latter, on the other hand, will be occupied with the job of vouching and examination of Final Accounts. Vouching means verification of entries in the financial books

with relative documents and evidences. It will also be the duty of Senior Assistants to supervise the day-to-day progress in work of the Junior Assistants. What the Senior Assistants do will again be checked up, in detail as far as practicable, by the proprietor or partners of the Audit firm. Before certifying the correctness of the Accounts and saying that the Balance Sheet exhibits the true state of affairs of the concern, much care should be taken from all aspects. The three sets of persons, viz., Junior Assistants, Senior Assistants and the Management would do well to use three different inks for 'ticks'. A reputed Calcutta firm, for instance, uses *Violet, Green* and *Red inks* respectively for the above three categories of persons. Different tick marks should be used for casting, posting & vouching.

Method of office work

Every Audit Assistant should be supplied with a Diary Book. This diary will have a record of daily work in detail. An Audit programme should be drawn up on the lines indicated in the following page before commencement of a particular Audit and kept in the *Working file.* From this Audit programme, the Management is in a position to see whether a particular Audit is profitable or not. Besides, there is no scope for an Audit Assistant to while away his time. For, the time spent on the last Audit of the particular job is indicated in the last year's Audit programme.

Audit office Records

For every particular Audit, there should be a separate working file. This file would contain a detailed record of previous Audit done. Besides, certain other important Documents should also be there in the working file. These are (a) letter of appointment, stating scope of duty, from the sole trader or partners and in the case of a joint stock company, copy of certified Resolutions of shareholders regarding Auditor's appointment ; (b) certified statement from the client of Accounting method employed and of Internal Check in operation ; (c) certified list of financial Books ; (d) list of responsible officers, their duties and specimen signatures ; (e) copy of Partnership Deed in the case of a partnership and in the case of a company, copy of the Memorandum of Association, Articles

of Association, the Managing Agency Agreement, the Vendor's Agreement and copies of important contracts ; and (f) the Audit Programme. This working file will be of great help when a new person is deputed on the job.

Working File

Financial Books	Signature of Assistant doing the job	Time taken on the job	Auditor's cost at hourly rate of the employees
1. CASH BOOK			
(*a*) Casting			
(*b*) Posting			
(*c*) Vouching			
(*d*) Bank Reconciliation			
2. SALES DAY BOOK			
(*a*) Casting			
(*b*) Posting			
(*c*) Vouching			
3. BILL REGISTER			
(*a*) Casting			
(*b*) Posting			
(*c*) Vouching			
4. PURCHASES DAY BOOK			
(*a*) Casting			
(*b*) Posting			
(*c*) Vouching			
5. JOURNAL			
(*a*) Casting			
(*b*) Posting			
(*c*) Vouching			
6. VERIFICATION OF FINAL ACCOUNTS			
7. VERIFICATION OF SCHEDULES			

There should be an Audit Note Book for every Assistant. In this book will be noted all Audit objections against and discussions with the client. The Note Book will also record work to be taken up next after the present job is completed.

Audit Note Book

QUESTIONS ON CHAPTER III

1. It is said that the efficiency of an Auditor depends upon (i) his knowledge of Law and Accounts, (ii) his capacity for taking pains, (iii) his act and patience and (iv) the strength of his common sense. Explain the utility of each of the above qualifications. (B. Com.)

[*Hints* : If the Auditor is ignorant of the Company Law, Partnership Act, sales tax and income tax Regulations and other important, relevant laws and bye-laws, the Balance Sheet of his client may remain defective. His lack of knowledge in Accounting may lead to non-detection of manipulation and falsification of Accounts. The Auditor must be painstaking ; else, it will be difficult for him to detect errors and fraud. Tactfulness and patience are also virtues demanded of an efficient Auditor. While Audit objections are settled with the client, the Auditor has to be very tactful and he must not lose temper or annoy his client by unnecessary questions. With all his patience he should conduct the Audit. For instance, at the time of vouching the Receipt side of the Cash Book, he should carefully scrutinize the consecutive numbers of all the Receipt counter-foils to guard against misappropriation of cash. Needless to say, the possession of a strong common sense will always stand the Auditor in good stead and help him in coming to a quick decision at critical stages.]

2. What procedure and method of work should a newly started Audit firm follow to conduct its Audit ?

3. What is an Audit Programme ? You are the Auditor of a partnership business Draw up your Audit programme to carry out an efficient Audit.

4. Give your view as to whether a *fixed* Audit Programme should be followed.

[*Hints* : If the programme of Audit is on a line defined and chalked out beforehand, the total volume of task can be completed quickly and there is little chance of any important work being omitted. Fixation of, responsibility in Audit work is rendered easier. The sudden leaving of the Audit firm by a member of the staff does not cause a dislocation of work, as the new person taking up the job will easily follow the link.

The main disadvantage is that the Audit becomes mechanical and goes on a stereotyped line. New developments in the business are totally ignored. If the client is aware of the extent of Audit to be carried on over certain financial Books every year, chances are that he will manipulate in the portions where Audit will not be conducted under the fixed programme. Hence the programme should desirably be *variable* for enforcing a moral check.]

5. State the Records and Documents which will be kept in the permanent working file of the Auditor.

6. Explain the nature of Audit Programme and Audit Note Book and state the purposes which they serve.

(National Diploma in Commerce, Government of India)

7. How should work be divided among different categories of Audit personnel for a smooth and efficient conduct of Audit ?

CHAPTER IV

MODES OF AUDIT

Considerations for a non-company Auditor before commencement of a New Audit

The Auditor for a sole trader or for a partnership has to obtain *a letter of appointment* from the client. The Auditor's scope of work, terms and duties will be clearly laid down in the letter. The Auditor in these cases should be on his guard that there is no ambiguity in the language of the Appointment Letter. Next he should proceed to know of as much information about his client as can be gathered.

Considerations for a company Auditor before commencement of a New Audit

Where the Auditor is appointed for the first time for a limited company his duty will be to obtain through the Company Secretary a certified copy of the Directors' Resolution on the strength of which he is appointed. He is also to examine the Directors' Minute Book to verify the authenticity of the Resolution passed. In cases of subsequent appointments, the Auditor has to get from the Company Secretary a certified copy of the Resolution passed at Shareholders' Annual General Meeting. And this is to be verified from the Shareholders' Minute Book. Having satisfied himself that his appointment is regular, the Auditor, before commencing his work, should carefully study the Memorandum, the Articles and the important contracts entered into by the Company.

Considerations for an Auditor appointed by the client in place of another

Where a new Auditor is appointed in place of another who held office for the previous period, the newly appointed Auditor is to write a courtesy letter to the predecessor. In this letter he should let know of his appointment and inquire whether the former Auditor has any objection in the matter.

Matters to be looked into before commencement of Audit

Before commencing Audit, the Auditor should visit his client's place of business and carefully study the following matters :

(i) Nature of work and business technique.

(ii) Guiding Documents, such as the Memorandum of Association and the Articles of Association of a limited company or the Partnership Deed of a firm.

(iii) System of Accounting employed and Internal Check in operati[illegible]

(iv) Names of Books[illegible]ount Books, Memorandum Books & Statistical Books—and the nature of record therein.

(v) Names of officials holding key-posts—the specific jobs they are engaged upon and their signatures.

(vi) Report of the previous Auditor and his audited accounts.

Fortified with all these information and explanations had from persons at the helm of affairs, the Auditor will start his audit work. Important matters should preferably be taken note of, in black and white, in the Audit Note Book.

Internal Check

The Auditor would do well to enforce a sound system of internal check. *Internal Check* means an arrangement whereunder the work of one Assistant is made to be verified by another. Through such checking chances of error are minimised and misappropriation of cash or of goods rendered difficult. An arrangement like the following may, for instance, be in operation for internal check regarding the Cash Book. The cashier will be entrusted with the task of receiving cash and issuing receipts to parties from the Receipt Books, each containing 100 receipts with counterfoils and bearing consecutive numbers. Payments will also be made by the cashier through 'Account Payee' cheques only, after he has got payment vouchers duly passed by some responsible officer and supported by Parties' Bills and Receipts. After the close of the day's

transactions, (i) Receipt books with counter-foils and (ii) Payment vouchers accompanied by the Bills and Receipts from Parties will be forwarded by the cashier to the Accounts department. From these records the Cash Book will be written by an Assistant of the Accounts department. In no case should the cashier be allowed to make entry in the Cash Book. A responsible officer will check all the entries of the Cash Book, referring to relevant documents and records and verify the Cash balance in Hand as shown by the Cash Book He should occasionally count cash, by surprise, from the Cash Box which will be in the possession of the cashier. This is for checking whether the Cash in Hand as per Cash Box agrees with the Cash Book balance

Internal Audit

Another process, known as Internal Audit, is also very effective in the detection of errors and discrepancies. Under the process, a batch of employees of a concern will be engaged for checking the record of the day-to-day transactions independently. They are to report to the Management weekly about the work done by them. *Internal Audit should be carefully distinguished from Internal Check.*

Internal Control

It is advisable that a system of Internal control be in operation, wherever possible, in an organisation. This would mean exercise of vigilance over important matters like budget and finance, purchases, sales, etc, by the Management. This control would come from the proprietor in a Sole Proprietorship, from the active partners in a Firm and from the directors in a Limited Company.

Test Check

Test check indicates partial checking of the record of transactions done in financial Books. For example, if three months' entries in the Cash Book or in any other Subsidiary Book are checked thoroughly, instead of there being a complete checking of the whole year's record, it will be a case of 'test check'. Similarly, while verifying 'Closing Stock' if some big items from the inventory are picked up by the Auditor and counted, measured or weighed, it will be an example of test check.

How far the practice of test check can be adopted by the Auditor has to be examined. Where there is an *efficient* system *of internal check coupled with internal Audit*, test check may be relied upon. It should, however, be remembered that if during test check, some mistakes are detected, a full and comprehensive Audit will be necessary.

QUESTIONS ON CHAPTER IV

1. You have been asked to audit the First Annual Accounts of A B & Co., a newly established private firm consisting of three partners.

Describe the information you would ask for before commencing the Audit. (M. Com.)

[*Hints* : The Auditor will first of all visit the client's place and try to collect maximum information about the *nature of business, the method of keeping the Accounts, the system of Internal check employed, the provisions of Partnership Agreement and the allotment of duty to the partners.*]

2. You are appointed the first Auditor of a firm consisting of several partners. What information must you call for before undertaking the Audit ? (B. Com)

3. You have been requested by a Sole Trader to audit his accounts for the first year of his business ended December 31, 1946. Set out the order in which you should proceed to execute your work. (B. Com.)

[*Hints* : After determining the scope of work from the letter of appointment, the Auditor will usually proceed to execute his work in the following order :—

(a) Vouching of the Cash Book and checking up of the Bank Reconciliation Statement ;

(b) Vouching of the Purchases & Sales Books, the Journal and other subsidiary books like the Bill Register ;

(c) Castings and Postings of all the financial Books ;

(d) Verification of Final Accounts with supporting schedules ; and

(e) Submitting Report of Audit to the sole trader.]

4. What are the considerations an Auditor should bear in mind on the commencement of a new Audit ?

(Chartered Accountants)

5. Describe briefly what steps you would take before commencing the detailed work of the Audit of a newly formed limited company.

6. A Chartered Accountant has been asked by the partners of a firm to take up the Audit of their accounts. State what steps he will take before he actually commences the work. (B. Com.)

7. What is the exact significance of the term 'Internal Check' ? How will you satisfy yourself that there is a suitable system of internal check in a large manufacturing concern with regard to (a) Cash Sales and (b) Credit Purchases ?

[*Hints*: The Auditor will be satisfied as to the system of internal check in operation regarding cash sales of his client if he finds that the sales proceeds are all promptly recorded in the Cash Book and the record is checked independently by a responsible officer. The cash sale collections should be receipted through National Cash Register wherever installation of this appliance is possible. To avoid there being misappropriation of cash the Auditor should disapprove of the practice of Cash Book being written by the person collecting the cash from Parties.

The credit purchases of a large manufacturing concern may be taken to have been duly recorded if the following things are complied with :--

(a) The purchases are always made only on the strength of Indents issued from the department requiring the goods and sanctioned by some responsible official in charge of the purchases.

(b) On arrival of the goods, the matter is recorded in the Goods Inward Book in detail.

(c) After goods come under the custody of the store-keeper, he issues a Store Receipt stating that the goods have been stored in good condition and forwards that Receipt to the Accounts Department]

8. (a) What do you understand by the term 'Internal Check' in Auditing ? (b) Examine the position of an Auditor of a limited company in relation to internal check operating in the business.

[*Hints* : Where, to the satisfaction of the Auditor, an efficient system of internal check is in operation in a limited company, the Auditor may free himself from the onerous task of doing a detailed and complete Audit. Instead, he will do what is called 'test check'. Test checking means bringing only certain portions of the record in the financial books under examination. If in the portions examined, no glaring mistake is found, it may be assumed that the rest of the record is also error-free. If, on the other hand, serious mistake is discovered in course of test-checking, the Auditor has to arrange a detailed Audit. As a company Auditor is the custodian of the interests of shareholders, he should not take to test-checking so liberally.]

9. Record a comprehensive system of internal check with regard to the Buying and Selling departments of a manufacturing concern.

[*Hints* : The Buying and Selling departments of a manufacturing concern should be under the charge of persons of executive rank. All purchases and sales must be made under sanction from a responsible official and through the Order Books. Due entry should be made in the Goods Inward Book and the Store Receipt issued for all purchases. For every sale, proper record must appear in the Goods Outward Book. A separate staff employed by the Management should re-check the Order books, Purchases and Sales books, Goods Inward and Goods Outward books, and other relevant books and documents connected with purchases and sales. There should be co-ordination between the Buying and the Selling departments and proper watch should be kept on the stock-level with the help of Bin Cards. All precautionary measures should be adopted for minimising chances of goods defalcation.]

10. What do you understand by internal check? Do you think an internal check system can be made absolutely reliable? How far can an Auditor rely on such a system in discharging his duties to the shareholders? (B. Com.)

11. What is meant by 'Internal Check' in Audit? Mention some types of business where internal check is very essential, giving reasons for your answer.

[*Hints* : Internal check must be in operation in a retail shop doing large volume of cash sales, in a Manufacturing concern producing a large variety of articles and in Druggists' shops and other establishments where big stores are held.]

12. With a view to preventing a repetition of extensive fraud in relation to cash sales, you are requested by your client to outline a system of internal check which will effectually close any loopholes at present existing. Suggest some special matters which should receive attention. (B. Com.)

13. State briefly what is meant by 'Internal Check' and 'Internal Audit'. To what extent do these affect the work performed by an Auditor of a limited company ? (M. Com.)

[*Hints* : By *internal check* is meant an arrangement whereby the entries made by one or more persons in financial books are verified by another set of persons under the same management independently by reference to records and documents. *Internal Audit*, on the other hand, means that a separate staff, known as internal Auditors, are engaged throughout the year to check the entries passed in the books of accounts. The duties of a Statutory Auditor are minimised to a considerable extent where 'internal check' and 'internal Audit' are in operation. Instead of doing an exhaustive Audit he may conduct a partial Audit of sales, purchases and other non-cash and cash transactions. But, for the verification of assets like Investments, Sundry Debtors, Closing Stock, Cash and Bank balances. etc., it will be the duty of a Statutory Auditor to make a comprehensive and detailed Audit.]

14. Give instances of irregularities which are likely to occur in absence of proper internal check on "Cash Sales". (Chartered Accountants)

[*Hints* : In absence of proper internal check on "Cash Sales" the following irregularities may occur : defalcation of cash ; suppression of cash memos resulting in short collections ; removal of saleable articles from the shop causing thereby defalcation of goods ; issuing of false cash memos and thereby misappropriating the cash collected.]

XIX. What is meant by (1) Internal Audit, (2) Internal Check and (3) Test Check ? (Chartered Accountants)

16. Outline a system of internal check calculated to prevent the following types of fraud :—

(i) A Bank Manager allows credit without security knowing that the borrowers have no means to repay.

(ii) Stock is written up in order to augment profits. The Manager is entitled to 10% on profits of the firm.

(iii) Cheques are drawn against false vouchers.

[*Hints* : (i) A responsible official of the establishment should check the monthly closing balance of the customer's accounts by reference to the Overdraft Security Register to arrest the fraud. If any securities were lodged to cover the credit, this would appear in the above named register. (ii) A responsible person from the Management should make a physical verification of the closing stock by reference to the stock inventory showing closing quantities and valuation. This would prevent over-valuation of stock. (iii) If some responsible official independently checks all the payment vouchers with counterfoils of cheques issued, irregular payments may be avoided.]

17. It has been suggested that one of the dangers of the mechanization of accounting records is to increase the possibility of fraud. Discuss this contention. (Chartered Accountants)

[*Hints* : It is a wrong belief that mechanization of accounts tends to fraud. This belief is strengthened by the fact that loose leaf cards are employed for record-keeping which may be replaced for fraudulent purposes. But if there is an internal control over these cards, they cannot be replaced without the knowledge of the Management. Chances of fraud are rather much less under the mechanized system. For example, the Cash Book is prepared independently in the machine section from the counterfoils of the cash receipts and payment vouchers supplied by the cashier. If there is an internal check of the entries made by the machine section in the Cash Sheets, there is no chance of fraud at all. But where in a small business the whole operation is in charge of one or two persons, there may be chances of fraud if the accounts are compiled by the machine.]

CHAPTER V

ROUTINE CHECKING

Routine checking—its meaning and scope

Checking of castings and postings in the financial books, although of a mechanical nature is a matter of fundamental importance. *Casting* means the work of totalling and *posting* signifies taking matters already recorded in books of Original Entries into Ledger. Routine checking of castings and postings will reveal errors, if any. If this is not done in a thorough manner, errors will remain undiscovered, and consequently, the Trial Balance will not agree, and the Final Accounts cannot be drawn up.

Reliance of the Auditor on Internal Check or Internal Audit

If *there exists an efficient system* of Internal Check or Internal Audit, the Auditor's duties are minimised. For, the Trial Balance is periodically drawn up and made to agree. In such cases, the Auditor will only do a *'test check' of the castings and postings* in the financial books.

On what lines Routine Checking will be conducted

The Cash Book should be brought under a thorough checking where internal check is not in operation. After the castings have all been examined, the postings will be checked by reference to relevant accounts in the ledger. It has to be taken note of that for one Cash Book entry, ledger posting will be only in one account in the ledger—either on the debit side or on the credit side. For, the Cash Book is itself a ledger, serving the purpose of Cash Account. In other cases, for instance, for one Purchases Day Book entry, ledger posting will be in two accounts of the ledger, viz., the Purchases account *and the Supplier's account. The postings from the Purchases* Day Book will be as follows. The Supplier's Account will be credited in the ledger as and when a transaction is recorded in the Purchases Book. And the Purchases Account in the Ledger will be debited with the total amount of purchases of a particular

period, such as a week, or a fortnight, or a month. Likewise, in checking the postings of the Sales Day Book it should be seen whether the Customers' accounts have been duly debited and the Sales account credited with the periodical totals. The same practice should have been followed in the matter of postings from other books of Original Entry. The castings of Petty Cash Book should be checked in full. The postings from this book are to be examined with the General Cash Book for moneys obtained and with respective ledger accounts for nominal expenses. In a concern where transactions are numerous, the task of postings and their subsequent checking will be rendered easier, if the Ledger were divided into three parts : (a) General Ledger (b) Sales Ledger or Sold Ledger and (c) Purchases Ledger or Bought Ledger. The General Ledger will contain all accounts other than the personal ones. Personal accounts will find their place in the Sales Ledger, where the accounts are of customers to whom goods have been sold and in the Purchases Ledger, where the accounts are of suppliers from whom goods have been bought. The checking of castings and postings of the Journal Proper should preferably be done in full. Postings from the book will be made in the General Ledger. The castings and postings of other Subsidiary books like Bill books, Return Inward and Return Outward books, &c. should also engage the attention of the Auditor. It will also be the duty of the Auditor to check the casting of the Trial Balance and the Final Accounts with supporting schedules. The system of checking the castings and postings as indicated above is known as 'Routine Checking'.

QUESTIONS ON CHAPTER V

1. What is the meaning of the terms : 'castings' and 'postings' ? Appraise their importance.

2. Should it be the duty of the Auditor to check the 'castings' and 'postings' in full where the Trial Balance agrees ?

[*Hints* : If there is internal check *or* internal Audit in operation, the Auditor may do a 'test check' ; otherwise, he will conduct a detailed check for the detection of compensating errors, or errors of principle, if any.]

3. What do you understand by the term 'Routine Checking' ? Illustrate your answer.

CHAPTER VI

VOUCHING

Meaning of the term 'Vouching'

Vouching means examination of the record of a transaction with reference to documentary evidence. In support of an entry in the financial books a document has to be kept ready serially arranged and to be produced before the Auditor for scrutiny. This document is commonly known as *voucher*.

Cash Book Vouching :

Before undertaking Cash Book vouching the Auditor must ascertain the extent of internal check in operation. If the internal check is on sound lines, the Auditor may do 'test check' of cash transactions. The Auditor should insist on the practice of *the cashier not writing up the Cash Book.* For, a scope of fraud is always there if the Cash Book is in charge of the cashier. The person authorised to sign payment vouchers should be a responsible official and with his signature the Auditor has to be fairly acquainted.

Vouching of cash receipt transactions

The Auditor should see to it that the person having authority to receive cash remitted to the client and to open envelopes containing cheques, postal orders, etc., brings all receipts to the notice of somebody holding a responsible position in the concern. The cheques and postal orders should preferably be crossed "A/c Payee only". The assistant entrusted with the task of making entries in the Cash Book should be a person other than the one receiving cash remittances. The Cash Book writer, instead of being a person attached to the Cash Department, should preferably be one belonging to the Accounts Department. Under lock and key and at the custody of a responsible official will lie the Cash Receipts Book with counterfoils bound and consecutively numbered. The cashier will take the Book, when for a cash receipt necessary document is to be prepared. The Auditor should be particular about the

non-recording of a cash that has been received. A case like that may arise if the cashier makes the counterfoil of the Receipts Book disappear, the original having been duly issued to the party making the payment. If the Auditor is careful enough to check up whether the numbers of the counterfoils are in consecutive order. chances of fraud as referred to above can be minimised. Where the appliance 'National Cash Register' is in use to record the daily receipts, the Auditor should check up the recordings of daily collections on the tape and verify this by reference to entries in the Cash Book debit side. In case of money collected on account, that is, from debtors who bought goods earlier on credit, complete vouching will require examination of the cash receipt evidence together with office copy of the challan prepared when goods were sold. Also is to be examined the copy of Bill sent to the party. In the matter of examining the receipt of Investments yield, the following measure should be adopted. The Auditor will ask for the Investments Ledger. In this ledger there should be separate accounts for each Investment indicating on top the dates on which interests or dividends are receivable. The Auditor is to see that all interests and dividends have been realised by the due date and he is to take the Bank Advice and the Dividend Warrant under his examination. Similarly, where Rent is receivable or any other source of cash receipt is there, the Auditor should verify whether these moneys have been duly collected or not in time and he should scrutinize the relevant agreement with the parties concerned. To verify receipts on account of Interests on Bank Deposits the Pass Book entries must be examined. For interests receivable on Loans granted to parties, the terms contained in the Mortgage Deed are to be consulted, if the loan is a secured one ; in case of an unsecured loan, the Agreement with the party concerned will serve as the guiding document. For money realised on the discounting of a Bill of Exchange, the record in the Bills Receivable Book and in the Bills Discounted Book together with the Bank statement showing the rate of Bank Discount should be carefully examined.

While vouching the Receipts side of the Cash Book the Auditor would do well to bear in mind the chance of a fraud as narrated below. It is possible that the cashier in collusion

with the Cash Book writer will have managed not to send the collected cash & cheques to the Bank, there being due record of such collections in the Cash Book. The Auditor can arrest such fraudulent practices by making a test checking of the counterfoils of Paying-in-slips. He will insist on the daily collections being deposited into Bank the same day or the day next.

Vouching of cash payment transactions

The vouchers related to cash payments should all be serially numbered and filed chronologically, that is, in order of date. The filing has to be in accordance with the order of entries on the Cash Book credit side. It should be especially looked to whether a payment has been made in connection with the authorised business of the concern and whether the payment has been made to the right party. The bills submitted by parties should be in the printed form. It has to be seen that the payment voucher has been passed by one in authority. The Auditor should also make sure that the signature of the party receiving payment is genuine. While examining the payment voucher, the Auditor will pay attention to the head of payment. A proper distinction between Revenue payments and Capital payments must have been observed. A list shall now be drawn up by the Auditor of all payments for which there are no vouchers. And this should be recorded in the Audit Note Book. be settled with the Management as soon as possible.

Whenever any Plant and Machinery have been purchased, the Auditor is to examine the original Invoice from the suppliers and their Receipt, together with Public Carrier's Bill of Cost. If the machinery is imported from abroad, the Customs Duty Receipt and the Port Commissioner's Landing and River Due Receipts are to be examined. In the case of purchase of Furniture, the seller's Invoice and the cartage Receipt will be the supporting documents to be scrutinized by the Auditor.

Vouching of Capital payments

When a Building is constructed, the Contractor's Bill of Cost should be taken into consultation. But when a Building is purchased, the Solicitor's Correspondence and the Title Deed of the Building should be examined.

3

Whenever any payment is made to the staff on account of salaries, the Auditor will vouch every payment with reference to the salary payment (book*) and he is to see that there is proper receipt for every payment. In the matter of wages payment the Auditor will particularly examine the system of payment and the nature of internal check in operation. It is advisable to have a Time Recording Clock at the entrance gate of each factory. And this checking should be in charge of a Foreman. When a workman reports for duty, he is to get his card duly punched on the Time Clock and have it handed over to the Foreman. The Foreman will, from this card, prepare the Muster-Roll (Attendance Register). This Muster-Roll will be the basis of payment of wages to the Time Workers. Separate cards of a different colour will be issued to those working on piece rate and their cards will be filled up by the Foreman of the shop where they are employed, indicating the jobs they have completed. These cards will be the basis for preparation of the wages sheets from which the payment of piece rated workers is to be done. The Auditor should check the rates and calculations on the Muster-Roll and the Wages Sheets in order to see that overpayment is not made. He should suggest to the Management that on the payment day the Manager and the Foreman should be present on the spot. They will see that payment is done to the right person. To create a moral impression, it is advised that the Auditor will also pay a surprise visit on the date of payment occasionally.

Vouching of Payment of Salaries and Wages

The Broker's Bought Note and Receipt should be examined by the Auditor for vouching the purchase of Investments. And the Stock Exchange Gazette quoting prices prevailing on the date of transference of the securities ought to be consulted in order to see that proper rates of purchase were charged.

Vouching of Investments

The correspondence in this connection has first to be looked into The Receipt from the borrower will also be the supporting document, where the Loan is without security. If the Loan is on Mortgage the Mortgage Deed and the Title Deed of the Asset

Vouching of Loans advanced to parties

* This book, in official terminology, is known as Acquittance Roll.

mortgaged together with the party's Receipt are to be examined.

Vouching of Agent's and Traveller's Commission

To establish the authenticity of commissions paid to travellers and agents, the agreement entered into with the traveller or the agent should be examined. The Statement of Accounts with supporting vouchers submitted by the agent or traveller should also be examined by reference to the payment voucher.

Petty Cash Book vouching

The Receipts side of the Petty Cash Book should be vouched by reference to the Requisition slips and the Petty Cashier's Receipts along with the credit entries of the General Cash Book. The Payments side of the Petty Cash Book should be vouched with supporting vouchers duly receipted. Also, it should be looked to that the total payments do not exceed the Imprest.

Vouching of Purchases Book

Purchases recorded in the Purchases Book should be vouched with original Invoices and the suppliers' Receipts. It should be seen that some responsible officer is in charge of the purchases. In this connection the Order Book should also be scrutinized. All the goods bought are to be traced into the Goods Inward Book where appears the record of the goods bought and their movements. Else, goods may be purchased and sold outside by unscrupulous persons for their personal gains. Hence, the importance of examining the Goods Inward Book thoroughly.

Vouching of Returns Outward Book

The Auditor should see that there is a proper system of recording the Purchases Returns. Goods may have to be returned, where the supply is not in accordance with the specification. The Manager or the Store Keeper should be advised to send intimation to the Accounts Department for the preparation of Debit Notes to the suppliers. And the Auditor should vouch the Returns Outward Book with the copies of Debit Notes, the original whereof is to be sent to the creditor.

The Auditor has to vouch the Sales Book with copies of Outward Challans, the originals of which are sent to the customers. It is advisable that some responsible officials will

be in charge of sales. The Order Book should also be taken into examination together with the Goods Outward Book, which records movements of the goods sold. In this connection the Bill Register and copies of Bills should also be scrutinized in order to see that proper Bills were issued to the parties for Credit Sales. In case of cash sales, the Auditor should ask for the Cash Memo* and see that they are consecutively numbered. If National Cash Register is in operation, the Tape Record of all cash sales should be examined.

Vouching of Sales Book

The customers of a concern may not sometimes approve of the goods supplied. And the practice in the mercantile world is that of taking back such goods as do not meet the buyer's approval. The Auditor should vouch the Returns Inward Book by reference to Correspondence with parties and the Debit Notes rendered by them.

Vouching of Returns Inward Book

At the time of vouching the Journal Proper the Auditor is to see that there has been no violation of the principles of Accountancy. The Journal Proper will record the opening entries, closing entries, transfer entries, adjustment entries, entries for rectification of errors and such other entries as cannot be recorded in any other Subsidiary Book. The persons signing the vouchers related to the Journal Proper should all be very responsible officials. The Auditor will scrutinize each entry by reference to vouchers and relevant documents and see that correct entry has been passed. For, manipulation of accounts can easily be made through the Journal. Care should be taken to see that no revenue item has been capitalised and *vice versa*.

Vouching of Journal Proper

The journey of all Bills recorded in the Bills Receivable Book and the Bills Payable Book should be carefully watched for. Entries in the Cash Book and the Bank Pass Book and in the Accounts for debtors and creditors appearing in the Ledger are to be examined. The Auditor should inspect the Bills that are still current on the Balance Sheet date and ask for the parties'

Vouching of Bill Books

* Memo.: abbreviation of the word 'Memorandum'.

Statements of Accounts. The counterfoils or copies of Bills accepted will be the supporting documents for transactions recorded in the Bills Payable Book. On maturity if payment has been made by the client, the evidence of the payment will be found in the returned Bills. For the dishonoured Bills the noting charges must have been duly recorded in the Books. The Auditor has to see that on the renewal of a Bill, the interest is duly provided for. And if an early payment is arranged for a Bill, there ought to be a record for the rebate allowable on such payment

Vouching of Hire Purchase Day Book

Goods may be bought or sold under a hire-purchase agreement or under an instalment agreement. In both cases payment is done in a number of instalments, each instalment money covering (i) *price of the Asset* bought or sold, and (ii) *interest* for deferring the payment. Under hire-purchase agreement the ownership of the Asset does not pass on to the buyer till all the instalments are paid off. Under instalment system the case is otherwise. The buyer acquires full ownership as soon as the contract is entered into. Should he fail to pay any of the instalments, the vendor, i e., the party that has done the sale, cannot claim the Asset back to his possession For, the property in the goods he has already parted with at the very time of sale, even though the instalments remained unpaid. Hence all the vendor can do by seeking the help of law is to get the unpaid amounts realised along with damages.

For a proper vouching, in all cases the actual Agreement should be carefully examined by taking into account or by referring to the following :—

(a) Charging of the interest portion in the instalment to revenue (and *not* to the Asset Account);

(b) The documentary evidence of payment/receipt.

Deviations from the terms embodied in the Agreement should be promptly detected and objected to.

QUESTIONS ON CHAPTER VI

1. (a) What is vouching ?

(b) How would you vouch the undermentioned transactions ?—

(i) Interest and Dividend received ;
(ii) Purchase of Investments ;
(iii) Compensation received for a claim on an Insurance Policy. (B. Com.)

[*Hints* : For Interest and Dividend received, relevant entries in the Bank Statement and in the Investment Register should be seen. For *Compensation* received for a claim on an Insurance Policy, the insurance company's correspondence, claim papers, the insurance policy and the receipt counterfoil should be examined.]

2. Discuss fully what internal checks would be adopted in a big manufacturing concern for the preparation of Wages Sheets. (M. Com.)

3. Set out in detail a system of Internal Check that you consider will prevent fraud in connection with the payment of wages in a large manufacturing concern. (B. Com.)

4. (a) What are the various types of entries you come across in a Journal Proper ?

(b) Select four different transactions from a Journal Proper of a Limited Company, and state the type of vouchers you will expect for substantiating the transactions.

[*Hints* : The following are the usual matters recorded in the Journal Proper of a Limited Company :—Share Allotment, Share Call, Forfeiture of a share and Re-issue of forfeited shares. For entries relating to these transactions, the relative Resolutions of the Board meeting recorded in the directors' Minute Book, duly signed by the Chairman, should be seen together with the Application and Allotment Register.]

5. Mention the essential points to which an Auditor should devote attention in case of the following :—

(a) Payment of Income-tax on regular assessment.
(b) Insurance claim in respect of goods lost by fire.
(c) Expenditure to put into working order the old Machinery purchased during the year.

(d) Valuation of Stock sent out on consignment.
(e) Sale of shares *Cum*-dividend.
(f) Freight and Insurance paid on goods sold.

(Chartered Accountants)

[*Hints* : (a) The Income Tax receipt issued by the tax authorities and their assessment order.

(b) The Report from Surveyors (Landale and Clerk are the Surveyors in Calcutta) regarding the amount of gross loss sustained *less* amount expected to be recovered from salvage, the Insurance Policy, Correspondence with the insurance company and the Policy report.

(c) The Agreement with the repairing company, if any, the repairer's Bill of Cost duly receipted and the payment voucher bearing signature of some responsible official.

(d) The original invoice showing cost of the goods and the *proforma* invoice sent to the consignee.

(e) Broker's Sold Note with forwarding letter and the Receipt counterfoil.

(f) The document embodying the terms of sale (whether C. I. F. or not), the payment voucher and the insurance papers.]

6. State how you would vouch the following items in the accounts of a Public Limited Company :—

(a) Remuneration paid to the Managing Agents of the company ;

(b) Directors' Travelling and Hotel expenses to attend Board meetings :

(c) Purchase of Raw materials from a firm of which a Director of the company is the sole proprietor.

(B. Com.)

[*Hints* : For vouching purpose, the following should be examined :

(a) The Managing Agency agreement, the papers showing calculations of the remuneration due, the payment voucher and the provisions of the Companies Act.

(b) Sanction of the Articles of Association, Receipts from the recipient directors and documentary evidence that the expenses incurred were in connection with attending and returning from Board Meetings or General Meetings or were in connection with the business of the company.

(c) Minutes Book containing Board Meeting resolution.]

7. The Auditor of a large retail stores has failed to discover misappropriations in connection with cash sales. In what circumstances, if any, can he be held responsible ?

8. (a) The proprietors of a large factory request you to devise a system in the factory for preparation of wages records and payment of wages in as efficient a manner as possible.

Indicate the essential points that should, in your opinion, form a part of such a system.

(b) As an Auditor, what steps will you take to satisfy yourself that the system has been working well and the total of Wages account in the General Ledger represents the appropriate figure of wages of the factory ? (B. Com.)

9. In vouching a Cash Book you find the following payments :—

(i) Travellers' Commission, (ii) Staff salaries, (iii) Payments to builders on account of contract for erection of building, (iv) Purchase of Plant and Machinery, and (v) Purchase of some Municipal Debentures.

What proof would you require to satisfy yourself that the payment in each case has been correctly made ? (B. Com.)

[*Hints* : (i) Travellers' statement of accounts, Travellers' agreement and the receipt from them.

(ii) Salary Book and Service records.

(iii) Contractor's Bill of Cost and Agreement and the
(iv) Purchase Order Book, the Original Invoice and the payment receipt.
party's Receipt.

(v) Broker's Note and the Receipt and the Stock Exchange quotations.]

10. How would you verify the following payments appearing in the books of a limited company ?

(a) Purchase consideration paid to vendor ;

(b) Commission on issue of shares ;

(c) Debentures redeemed by purchase in open market ;

(d) Payments made under Hire-Purchase Agreement. (M. Com.)

[*Hints* : (a) Vendor's agreement and the payment receipt.

(b) Sanction of the Articles of Association, Contract with underwriter or broker, the payment receipt and the Share Applications bearing signature or Rubber Stamp of the brokers.

(c) Broker's Bought Note, his receipt, counterfoil of payment cheque and provisions of the Articles.

(d) The Hire-Purchase Agreement.

N.B. It should be seen whether depreciation has been charged on the full value of asset and whether the interests have been correctly calculated.]

11. A manufacturing concern of which you are the Auditor has suffered loss as a result of frauds perpetrated in the following manner :—

(a) Fictitious entries for 'goods returned' were passed through the books and posted to the credit of the personal accounts, the cash being misappropriated as and when received.

(b) Fictitious purchases were entered in the books and duly posted to the personal account. Subsequently cheques, purporting to be in payment of the accounts, were drawn out, endorsed and cashed and divided by and between the staff.

(c) Dummy men were included in the wages sheet and the amount divided between certain members of the staff.

State the steps you would take to detect such frauds. How can such frauds be prevented ? (M. Com.)

[*Hints* : (a) The Stock Records (Bin card &c.) showing incoming and outgoing of goods are to be verified by reference to entries in the books of accounts. It should be seen whether the Outward Challan of the customer returning the goods is there. Such frauds can be prevented if proper inquiry about the deal is made before sanctioning payment.

(b) The supplier's Outward Challan showing the description and price of the goods should be scrutinized with the receipts from party. Before the payment cheque is issued, proper examination on the above line should be made by some responsible official.

(c) Payments to dummy men can be detected if the names of the Wages Sheets tally with names appearing on *Punched Cards* issued for workmen and also with the names in Attendance Registers of

different shops. The Works Manager in conjunction with the Shop Foremen must be present on the pay day and supervise the weekly payment of wages. The Wages payment sheets should be prepared in the Accounts department from cards punched at the gate under the supervision of a gate Foreman.]

12. Describe what you consider to be the proper method of auditing the wages book of a manufacturer. (B. Com.)

13. State how you would verify the correctness of wages paid in a manufacturing concern and what internal check in the preparation of Wages Sheets should always be adopted. (B. Com.)

14. Tabulate the points that should be looked into by an Auditor in accepting a voucher in support of a receipt. (B. Com.)

[*Hints* : The relative papers in connection with the receipt of money should be examined together with the receipt counterfoil. If the money is banked, the pay-in-slip and the Bank's Statement should be seen. The head of account under which the amount has been received should engage the Auditor's attention for the allocation of income.]

15. What do you understand by vouching a payment ? How would you vouch the following :—Royalty, Preliminary Expenses, Share placing Commission, Hire-Purchase Instalments, Directors' Travelling and Directors' Remuneration ?

[*Hints* : Payment vouching means the authentication and verification of disbursements with relative payment vouchers and parties' receipts.

In addition to the payment receipt, counterfoils of issued cheques and Bank Statements, other supporting documents for the following payments will be as follows :

Royalty	Royalty Agreement and the Correspondence.
Preliminary Expenses	Provision in the Articles of Association and the Directors' Resolution.
Share-placing Commission	Contract with the broker or underwriter, sanction of the Articles, the Directors' Resolution, the Share Applications bearing stamp of the brokers or underwriters and entries in the Allotment Register.
Hire-Purchases Instalments	The Hire-Purchase Agreement, the correspondence and the Accountant's interest calculation statement.

Directors' Travelling	Sanction of the Articles, the Agreement with the Directors and the statement from directors that the travelling was undertaken for furtherance of the company's business.
Directors' Remuneration	Provision of the Articles, the Agreement with the Directors and the commission calculation statement prepared in keeping with Sec. 198 and Secs. 309-11 of the Companies Act.]

16. Indicate the points of difference between (a) Sales, (b) Consignments, and (c) Goods on Sale or Return.

What difficulties may be experienced if goods sent out on Sale or Return are initially treated as outright sales and afterwards treated as sales returns when they are not accepted by customers ? (B. Com.)

[*Hints* : In case of a sale the ownership of the goods immediately goes to the buyer. Consignment should be distinguished from sales, as, when goods are sent out on consignment, the ownership remains vested in the Consignor, the Consignee acting merely as an agent. Where goods are sent to customers on Sale or Return basis, in that case, too, the property in the goods does not pass on to the party until *Sale Advice* is received.

To treat the sending out of Goods on Sale or Return as sales would be wrong, because this inflates the sales figure improperly. The trading results will be affected by this inflation if the unapproved goods are returned after the financial period If the return is within the financial period, that does not affect the Gross Profit, but the sales records will be wrong even if the amount of sales is adjusted against the Returns Inward.]

17. What procedure would you as an Auditor adopt for checking goods sent to customers 'on sale or return' ? How should these transactions be treated in the annual accounts of the firm ? (B. Com.)

[*Hints* : The Auditor will check the Goods on Sale or Return Book with the copies of challans sent to the parties together with the correspondence in connection with Sale or Return Advices. When sales are effected, the amount of moneys received from party should be traced into the Cash Book after cash or cheque is received. In the case of credit transactions the amounts should be traced into the party's ledger account.

If the goods have been sold, it will be treated as outright sales ; otherwise, the goods lying with the party should be merged under Closing Stock.]

18. If you are required to audit and certify the total purchases and sales of a large business during the year, explain in detail the procedure you would adopt. (B. Com.)

19. Gautam Brothers have started a big departmental stores. They want you to suggest a system of internal check regarding daily cash takings. Incorporate in your report as many relevant points as you can. (B. Com.)

20. As an Auditor to a concern, to what points would you direct your special attention when examining the methods of dealing with moneys received ? (B. Com.)

21. For what purposes is the Journal used ? How is it to be audited ? (M. Com)

22. How would you vouch the following ?—

(a) Bad Debts written off.
(b) Customs and excise duties.
(c) Payments under hire-purchase.
(d) Directors' travelling expenses.

(*Chartered Accountants*)

[*Hints* : (a) Bad Debts written off should be vouched by reference to correspondence with the debtors concerned. The Auditor must be satisfied that adequate efforts were made to realise the amounts due. The tax authorities will not allow Bad Debts in the accounts unless evidence is shown to them that in spite of repeated reminders the amounts remained unrealised. The Auditor will also scrutinize the *Bill Register* in which the date of the Bill issued to party is indicated together with the date of realisation.

(b) The payment of customs and excise duties by the client is to be vouched with *Customs and Excise Receipts*. Where a deposit account is maintained between the client and the customs authorities, a lump sum money being kept by way of deposit to cover the Customs dues of merchants doing a regular import/export business, the payment should be traced from the *Pass Book* issued by the Customs authorities. On the Balance Sheet date they issue a *certificate of the closing balance* which should be seen by the Auditor along with the Pass Book.

Where numerous excise duties are paid as in the case of tea companies, the same procedure is adopted. A statement showing the adjustments of duties is furnished by the Excise authorities together with a certificate of closing balance on the Balance Sheet date. The Auditor should examine all of these documents.

(c) Payments under hire-purchase should be vouched by reference to the Hire-Purchase Agreement, Payment cheque counterfoil and the party's Receipt together with the correspondence in this connection.

(d) The provisions of the Articles of Association, T/A Bills submitted by Directors and the payment Receipt are the records to be examined by the Auditor in connection with vouching of Directors' travelling expenses. Expenses incurred for private purposes should always be disallowed.]

23. How would you vouch :

(a) Members' subscription received in the accounts of a football club.

(b) Partners' salaries in the accounts of a firm.

(c) Income from advertisement in the journal of a literary society.

(Chartered Accountants)

[*Hints* : (*a*) Subscriptions received from football club members should be vouched by taking the following documents into examination . (i) List of outstandings of members, (ii) Receipt counterfoils, (iii) Original applications of the members showing the date of admission, and (iv) the Members' Register.

(b) To vouch 'payment of partnership salaries', the following should be examined :(i) the Partnership Agreement, (ii) Profit and Loss Account showing allocation of profits among the partners, and (iii) partners' Receipts.

(c) To vouch 'income from advertisements appearing in the journal of a literary society,' the following should be examined : (i) contract with advertisers in connection with fixation of advertisement rates, (ii) the Advertisement Bill, (iii) receipt counterfoils, and (iv) the insertion of advertisements in the magazines.]

24. As Auditor you find that the following payments have been made by a company during the year :

(1) £3,200 to the company's stock brokers in respect of £4,000 4½ per cent Debenture Stock of the company purchased in the open market for the purpose of redemption.

(2) £8,000 to a former director of the company in consideration of his agreement not to take legal action in respect of the premature termination of his service agreement.

(3) £25,000 to the Trustees of the company's pension Fund. A supplementary scheme has been introduced to augment pensions under the existing scheme and the payment represents the amount necessary to provide for back service, in respect of the increased pensions.

(4) £500 to each of the directors of the company as allowances to cover travelling and entertaining expenses

(5) £1,000 to a contractor for the demolition of part of the company's existing premises to enable additional factory buildings to be erected.

State the evidence you would require to vouch each of these items, and indicate how you would expect them to be dealt with in the Annual Accounts of the company.

(Chartered Accountants)

[*Hints* : (1) To vouch the purchase of Debenture Stock in the open market by the Company for redemption the Auditor should inspect the following :—

(i) Provisions of the Articles of Association regarding Debenture Redemption.

(ii) Resolution of the Board of Directors authorising the redemption of Debentures through such purchases.

(iii) Debenture Trust Deed and provisions in connection with the redemption.

(iv) The Bought Note of the broker and his Receipt relating to the purchase. In the company's books the Nominal Value of Debentures redeemed should be debited to Debentures Account and the Debentures as shown in the Balance Sheet should be reduced by this amount.

(2) In order to vouch the payment of £8,000 to a former Director of the Company, the Auditor should examine the following :—

(i) The Agreement under which the payment of £8,000 was made.
(ii) The Director's Receipt showing that the payment was made in full satisfaction of all his claims.
(iii) The Profit & Loss Account (to see that such payment has been shown separately).

(3) To verify the payment of £25,000 the Auditor should see the following :—

(i) The original terms and conditions of the Pension Fund.
(ii) The conditions of the Supplementary Scheme.
(iii) The Trustees' Receipts for the payment.
(iv) The Resolution of the Board of Directors.
(v) A certified list of all the employees affected by the new scheme and the liability incurred to make provision for their past services.
(vi) Showing of the payment separately in the Profit & Loss Account.

(4) The payment of £500 to each of the Directors should be vouched by examining the following :—

(i) Sanction of the Articles of Association of the company.
(ii) Directors' Receipts and the evidence that expenses were incurred to foster the interests of the company.
(iii) The Profit & Loss Account (to see that the total amount paid is shown separately).

(5) £1,000 paid to a contractor should be verified by reference to the following :—

(i) The Correspondence and the Contract with the contractor.
(ii) The surveyor's Certificate authorising the payment.
(iii) The contractor's Bill of Cost and Receipt.
(iv) The counterfoil of the payment cheque.
(v) The Factory Building Account in the Ledger should also be seen to verify that such expenditure has been capitalised *or* in the alternative the Profit and Loss Account should be scrutinised to see that this amount has been charged as per Directors' Resolution.]

CHAPTER VII

THE STAGES FROM TRIAL BALANCE TO BALANCE SHEET

General Consideration

While scrutinizing the Trial Balance, the Auditor will particularly see that all outstanding expenses and accrued incomes have been brought into account. It will also be the Auditor's duty to see that all Ledger Accounts have been closed and properly balanced and grouped under separate headings. Capital items must have all been distinguished from Revenue items.

Where the Trial Balance does not agree

In case the Debit total of the Trial Balance does not agree with the Credit total, all the castings and postings of the Financial books should be brought under a thorough check.

Principles governing preparation of Accounts

In case of a trading concern, where finished goods are bought for resale, Trading and Profit and Loss Account will be prepared. In the first part of this Account will be revealed the Gross Profit, that is, the difference between the cost of Purchases (including the expenses connected with the purchases) and the Selling price. In the latter part of this Final Account will be shown the Net Profit (Gross Profit *minus* the Establishment expenses). Where goods are manufactured from out of raw materials bought, prior to preparation of ...d Profit and Loss Account, a Manufacturing Account ...pared, showing Cost of Production. This Cost of ...Cost of Manufacture will be thus ascertained. The ...of Raw Materials and that of Work-in-Progress ...anufactured goods) are to be added with ...w Materials during the period under review and ...t of this addition will be deducted the closing ...aterials and of Work-in-Progress. The resultant ...icate *the Cost of materials consumed.* To this

will be added Direct Labour (Wages paid to workers directly engaged in the process of manufacture at the factory) and directly chargeable expenses like Carriage Inward on Raw Materials bought, etc. The result of the addition, in costing phraseology, is known as Prime cost. To Prime cost will now be added items of factory expenses like Coal & Coke, Gas, Electricity, Water, Factory Rent, Depreciation on and Repairs to Factory Premises and Plant & Machinery. The Manufacturing Account will be debited with all of these items, the debit side total of the Account indicating the cost of Manufacture.

The idea behind preparing the Manufacturing Account is to find out the Cost of Goods Manufactured during the accounting period, and also the Cost of Manufacture *per unit* of goods or services. The Total Cost of Manufacture divided by the output will indicate the *Unit Cost*.

Adjustments

While preparing the Profit and Loss Account due adjustments should be made of all accrued incomes and outstanding expenses. *Else*, the correct trading results will not be revealed.

In the case of a Sole Trader or of a Partnership there is no specific form of Profit and Loss Account. But the Balance Sheet ought to be properly marshalled, i.e., the items should be arranged according to a system. The order of arrangement should be either of realisability or of permanence. If the first order is followed the assets that are more liquid will come first and on the liabilities side the items should be placed in order of priority of claim. The Balance Sheet will thus be in the first form as indicated on the next page.

Form of Profit and Loss Account and of Balance Sheet

If the order of arrangement is of Permanence the Balance Sheet will then assume the second form.

For a Joint Stock Company, the Profit and Loss Account and the Balance Sheet are to be prepared strictly in accordance with the form prescribed in the Companies Act, 1956, amended 1961, and this will be discussed in chapter XIII.

4

	Liabilities		*Assets*
Floating Liabilities (to be met first)	Sundry Creditors (*i.e., creditors from whom goods or services have been bought on credit*) Bills Payable Creditors for Expenses (*such as outstanding salaries & wages, outstanding rent, &c.*) Bank Overdraft	Floating Assets (not for being permanently held)	Cash in hand Cash at Bank Bills Receivable Investments Sundry Debtors Stock-in-Trade Prepaid Expenses Deferred Revenue Expenditure (such as *advertisement C/F &c.*)
Fixed Liabilities (to be met afterwards)	Reserve Fund Loans Capital* (*added* by Trading Profit and *deducted* by Trading Loss & by Drawings against profits)	Fixed Assets (For being permanently held)	Furniture & Fittings Plant & Machinery Copyright, Patents, etc. Land & Building Goodwill

	Liabilities		*Assets*
Fixed Liabilities	Capital Loans Reserve Fund	Fixed Assets	Goodwill Land & Building Copyrights, Patents, etc. Plant & Machinery Fixture & Fittings
Floating Liabilities	Bank Overdraft Bills Payable Outstanding Liabilities For Expenses Sundry Creditors	Floating Assets	Deferred Revenue Expenditure Prepaid Expenses Stock-in-Trade Sundry Debtors Investments Bills Receivable Cash at Bank Cash in hand

* Where capital is *fixed*, the Profit or the Loss should not be transferred to the Capital Account, but should appear under a separate account styled as 'Current Account'.

QUESTIONS ON CHAPTER VII

1. When called upon to discover errors resulting in disagreement of a Trial Balance prepared from a set of books, what steps will you take to agree the Trial Balance? (B. Com.)

2. Define a Balance Sheet and explain why, in the majority of cases, it is not a statement of assets and liabilities. (B. Com.)

[*Hints* : A Balance Sheet may be defined as a statement of Assets and Liabilities of a concern as on a particular date But this definition is not comprehensive if certain matters are taken into consideration. The Balance Sheet often contains items that are not, strictly speaking, assets as they are not possessed of the quality called 'convertibility into cash or kind', e.g., the fictitious assets. Also it has to be noted that the book value as shown on the Balance Sheet after providing for depreciation may not be the realisable value. Likewise, the liabilities side may exhibit items for which a concern is not immediately liable to make cash payment, e.g., an income received in advance, the undistributed profits, &c.]

3. (a) What is meant by "Prepaid Expenses"?
Give an example of such expenses. Why is such an expenditure called an asset?

(b) What is meant by "Deferred Revenue Expenditure"? Give an example. Why is such an expenditure treated as an asset?

(c) What is meant by the "Balance of Profit and Loss Account"? Why is the balance treated either as a liability or as an asset in the Balance Sheet?

(d) What is meant by 'General Reserve'? Why is it treated as a liability in the Balance Sheet of a business concern although at the same time it increases the value of the concern in the financial market?
(B. Com.)

[*Hints* : (a) 'Prepaid Expenses' are payment in advance for services yet to be received. Mention may be made of unexpired Insurance, Rent paid in advance, etc. These are assets as a concern will realise in future, in the form of service, the benefit of the payment already made.

(b) 'Deferred Revenue Expenditure' indicates an expenditure which is of a revenue nature but the benefit of which is spread over a number of years. Heavy amount spent on Advertisement or Preliminary Expenses incurred by a Joint Stock Company may be cited as examples. So long as such an expenditure is not written off, it is to appear on the Balance Sheet as an asset ; for, the benefit of the expenditure will be realised in the years to come.

(c) The 'Balance of Profit & Loss Account' represents either profit of a concern or its loss. In case of a credit balance, which means profit, the item will appear as a liability on the Balance Sheet, as the business is liable to its proprietors for making an account of the profit earned. If there has been a loss, the Profit & Loss Account will work out a debit balance and this will appear as an asset as if the amount were recoverable from the proprietors.

(d) "General Reserve" means a reserve created out of the divisible profits of a concern to enable it to overcome financial difficulties of an ordinary nature and also for strengthening its financial position. When there is a reserve of this kind, it reflects the soundness of the concern, but it has to be shown as a liability as it is but the aggregate of undistributed profits for which the proprietors are the creditors.]

4. After completing the usual routine audit of a retail stores you discover that there is an appreciable fall in the rate of the gross profit as compared with the previous year's rate. How would you satisfy yourself that the figure for the gross profit is correct ? (B. Com.)

[*Hints* : The Auditor will scrutinize the Purchases Book with invoices, particularly of the last month ; the Sales Book with outward challans ; and the Stock Book with necessary documents. This is for detecting manipulation, if any, in the figures of purchases, sales or stock.]

5. Your client wants your opinion as to whether the percentage of gross profits should be based on (i) Gross Sales ; (ii) Net Sales, (iii) Gross Purchase ; (iv) Net Purchases, (v) Opening Stock, or (vi) Closing Stock, so as to facilitate comparison of trading results from year to year. Draft a suitable reply giving reasons for your opinion. (B. Com.)

[*Hints* : The percentage of gross profit should be based on gross sales, because all the expenses incurred for buying goods

and their carriage to the place of business relate directly to gross sales. If the percentage is based on any other basis, comparison of trading results from year to year will be wrong ; for, gross profit has no direct bearing on purchases or stock.]

6. Supply suitable narrations to the following adjustment Journal entries and explain how each of the entries should be verified.

		Rs.	Rs.
(a)	Interest on Loan A/c. Dr.	785	
	to Rajkumar A/c. (Purchases Ledger)		785
(b)	Plant A/c. Dr.	2,700	
	To Profit on sale of Assets A/c.		2,700
(c)	Harijiban A/c. (Sales Ledger) Dr.	250	
	To House Rent A/c.		250
(d)	Building Repairs A/c. Dr.	1,850	
	To Building A/c.		1,850

Also, in each case give the original Journal entry to which the proposed entry is an adjustment. (B. Com.)

[*Hints* : Narrations to the adjustment Journal entries should be as follows :

(a) [Being payment of interest on loan debited wrongly to Rajkumar A/c. now adjusted.] This entry should be verified from the loan ledger and the payment voucher.

(b) [Being capital profit credited to Plant A/c. now rectified.] This entry should be verified from the Sold Note and the Fixed Assets Register.

(c) [Being House Rent realised from Harijiban wrongly credited to his personal account in the Sales Ledger, now rectified.] This entry should be verified from records in the Purchases Book and from the Rent Agreement.

(d) [Being Repairs to Building wrongly debited to Building Account now adjusted.] This will be verified from payment vouchers on account of Repairs.

The original wrong entries were as follows :—

(a) Rajkumar Dr.
To Cash

(b)	Cash	Dr.
	To Plant	
(c)	Cash	Dr.
	To Harijiban	
(d)	Building	Dr.
	To Cash	]

7. There is a partnership between a purdanashin lady, Malati and two gentlemen, Kalyan and Subrata. Malati cannot take part in the management of the firm. As per Agreement, each of the partners has contributed Rs. 10,000 towards capital.

On the unexpected arrival of a consignment of goods from U.S.A., it becomes necessary for the firm to pay Rs. 20,000 to their Bankers. This money is advanced by Malati.

At the end of the year, before the Final Accounts are drawn up, Malati claims interest on the Rs. 20,000 advanced by her and Kalyan and Subrata claim some allowance for the management of the business. There is no provision for any of these in the Deed of Agreement. The matter is referred to you as the Auditor of the firm. Draft a suitable reply. (B. Com.)

[*Hints* : Under the Partnership Act, in the absence of any agreement between the partners, no salary or allowance can be claimed for conducting the partnership business. If, however, any partner advances money to the business as loan an interest of 6% per annum is allowed.]

8. How do you distinguish between Manufacturing Account, Trading Account and Profit & Loss Account ?

The following results have been revealed by accounts of a firm for five consecutive years :

Year	Prime cost in Rs.	Gross Profit in Rs.	Net Profit in Rs.
First ..	25,00,000	12,00,000	5,00,000
Second ..	27,00,000	15,00,000	7,00,000
Third ..	32,00,000	20,00,000	11,00,000
Fourth ..	30,00,000	18,00,000	8,00,000
Fifth ..	26,00,000	14,00,000	5,50,000

Comment on the firm's working and suggest remedies for improvement. (B. Com.)

[*Hints* : Manufacturing Account is compiled for ascertaining the cost of goods manufactured during a trading period. Trading Account and Profit & Loss Account aim at finding out the Gross Profit and the Net Profit of the business respectively. On a comparison of the Percentages of Gross and Net Profits to prime cost it is revealed that there are wide variations which may be

checked if there is sufficient control over the purchases of Raw Materials, Direct Labour and all buying and selling expenses. The overhead expenses may also be scrutinized with a view to minimising the Cost with advantage.]

9. In course of your audit of the accounts of a workshop, papers signed by the Foreman concerned have been placed before you, which give the following particulars :—

MANUFACTURE OF 1000 DUST BINS FOR ALPHA ONE MUNICIPALITY

1944 Week ending May	*Raw Materials consumed* Cast Iron Sheet Quan. T.C.	Cast Iron Sheet Value Rs.	Paint Quan. lbs.	Paint Value Rs.	Misc. Stores Rs.	Wages Paid Rs.	Number of pieces delivered
6	1-5	500	12	240	75	225	30
13	2-15	1,100	25	500	140	460	60
20	3-10	1,400	32	600	200	800	85
27	6-5	2,500	95	1,900	500	1000	200

Comment intelligently on the above and explain what further investigation you should make. (B. Com.)

[*Hints* : On an examination of the Production Accounts it will be found that the number of pieces delivered is quite irregular week after week. This results in the variation in the Cost of Production of the pieces. The cost of raw materials and miscellaneous stores purchased and wages paid are not uniform. The Production Accounts, Store Records and elements of cost should be investigated to find the reason for variations.]

10. State the criteria you would use for distinguishing between the following :—

(a) Capital Expenditure ; (b) Revenue Expenditure ; (c) What is ordinarily known as Deferred Revenue Expenditure.

Give two examples of each and state how the items would be dealt with in the final accounts of a commercial undertaking. (M. Com.)

[*Hints* : (a) Capital Expenditure is incurred for the acquisition of Assets of permanent nature which are not meant for re-sale. Any expenditure for additions and replacements of such Assets is also of Capital Nature. For example, the amount spent by a Manufacturer to purchase Machinery and Tools is a Capital Expenditure.

(b) Revenue Expenditure is incurred in the general running of the business and for doing repairs and maintenance of the Assets of the business. Rent and Electricity may be cited as examples of Revenue Expenditure.

(c) Deferred Revenue Expenditure is such expenses the benefits of which extend to several financial years. For example, Advertisement expenses of a heavy amount and Development Expenditure are of this nature.]

11. What do you understand by the terms realised Profits, unrealised Profits, earned Profits and unearned Profits ? Explain with suitable examples. (M. Com.)

[*Hints* : (i) By realised Profits is meant that when some Assets are sold there is a gain in the transaction. For example. when a Machinery whose book value is Rs. 10,000 is sold for Rs. 12,000 there is a realised Profit of Rs. 2,000/-.

(ii) The term 'unrealised Profits' signifies that if the Assets or goods are sold at Market Price there will be a Profit. For example, when a Building shows a book value of Rs. 20,000 whose Market Value is Rs. 25,000 there is an anticipated unrealised profit of Rs. 5,000

(iii) Earned Profits imply net gain of a business. For instance, if the Profit & Loss Account works out a credit balance of Rs. 6,500, the amount indicates the extent of earned profits of the concern.

(iv) Unearned Profit is gain not earned in business. For example dividend received from a company on investments is an unearned profit.]

12. How are ledgers made self-balancing ? If self-balancing ledgers are in use in a business, would these be of any advantage to the Auditor ? (M. Com.)

[*Hints* : Ledgers are made self-balancing by opening adjustment Ledger Accounts in such a manner that a Trial Balance may be extracted from each Ledger. To make General Ledger self-balancing a Bought Ledger Adjustment Account and a Sold Ledger Adjustment Account should be opened in the General Ledger. Similarly, in each of the Bought Ledger and the Sold Ledger, a General Ledger Adjustment Account should be opened so that a Trial Balance may be extracted from each ledger. Where a self-balancing system is in operation the Auditor may rely on the Trial Balance and it is not necessary to tick all the items of Ledgers.]

13. While examining a Balance Sheet you find that the Fixed Assets at the close of the year have increased by 50% as compared to the previous year. What are the possible circumstances which may account for this ? State what corresponding change you would expect to find in the other items in the Balance Sheet.

(*Chartered Accountants*)

[*Hints* : If the Fixed Assets have increased by 50%, the circumstances accounting for this increase may be the following :—

(a) Overvaluation through the medium of Revaluation by Experts.

(b) Additions during the financial year by new purchases.

(c) Strong financial position in favour of acquisition of fixed Assets.

New purchases will affect the following items in the Balance Sheet :—

(a) Reduce the Cash and Bank Balances.

(b) Reduce Investments through sale of Securities to obtain money for the purchases.

(c) Reduce Loans and Advances through realisations.]

14. (a) Distinguish between 'Capital' and 'Revenue' expenditure and enumerate the reasons for such distinction

(b) State the requirements of the Companies Act, 1956 regarding the manner of showing the following assets on the Balance Sheet.

(i) Fixed assets.
(ii) Stock-in-Trade.
(iii) Sundry Debtors.

(*Chartered Accountants*)

[*Hints* : (a) See hints to Q. 10.

(b) (i) Fixed Assets must be shown at original cost less Depreciation up to the date of the Balance Sheet in accordance with Income Tax Schedule, distinguishing between various classes of Fixed Assets.

(ii) Stock-in-Trade must be shown at Cost or Market price whichever is lower.

(iii) Sundry Debtors must be divided under the following :

(a) Book Debts over six months.

(b) Other Debts (Current Debts outstanding for less than six months) *less* provision for Bad & Doubtful Debts.

Sundry Debtors must be further classified as under :—

(i) Secured Debts considered good.

(ii) Unsecured Debts considered good.

(iii) Debts considered Doubtful or Bad due by Directors or other officers of the company *or* Debts due by Firms or Private Companies respectively in which any Director is a Partner, a Director or a Member to be shown separately. Debts due by other companies under the same management (e.g., Subsidiary Companies) must be disclosed with the names of the Companies. The maximum amount due by a Director or other officers of the Company at any time during the year must be shown by way of a Note on the face of the Balance Sheet.]

15. Your clients, Rock and Roll Ltd., are engaged in the sale and maintenance of pianos, wireless sets and television sets ; they have about 5,000 tuning and maintenance contracts under which they receive regular quarterly payments from their customers. They have suggested to you that it might be more convenient to discontinue the existing bound ledgers for the accounts of all such customers, and to substitute hand-written loose-leaf ledgers. Give your views.

(*Chartered Accountants*)

[*Hints* : The introduction of Loose-leaf ledgers in place of bound ledgers is not desirable because they are not accepted in a Court of Law. Besides, the scope of manipulation of Personal Accounts is great, resulting in the defalca-

tion of Cash. When there are on the average 5,000 contracts in operation it is quite easy for the Accountant to falsify the Accounts after Continuous Audit to suit his own purposes. Therefore, it is not justified to introduce loose-leaf system of Ledgers.]

16. (a) Give three examples of a contingent liability.

(b) State, in each instance, what inquiries you would make, as Auditor, to ascertain whether any contingent liability in fact exists.

(Chartered Accountants)

[*Hints* : The examples are as follows :—

(i) Arrears of Fixed Cumulative Dividends

(ii) Pending law suits, say, for breach of contract.

(iii) Capital commitments entered into during the financial year.]

17. Explain the steps you would take, as auditor of a limited company carrying on business as wholesale distributors, to satisfy yourself that all current liabilities and provisions are included in the Balance Sheet.

(Chartered Accountants)

[*Hints* : The Auditor will check the following in detail :—

(a) The transactions of the last month as recorded in the Purchases Book with original invoices (to see whether any liabilities are excluded).

(b) The payment vouchers of at least three months after the financial closing date with particular attention to the parties' Bills and dates (to see whether any liability has been paid under normal expenditure head).

(c) The Income Tax File with Demand Notices and Assessment Orders (to see whether provision for taxation is adequate).

(d) Directors' Resolution for proposed Dividend.

(e) The Subsidiary Company's audited Balance Sheet (for liabilities to Subsidiary Companies).]

18. As Auditor of a Holding Company with Subsidiaries in various countries, you are examining the group accounts and ascertain that :

(a) The directors are of the opinion that the group accounts need not deal with a number of the Subsidiaries.

(b) The accounts submitted for one of the foreign Subsidiaries are unaudited.

Discuss your position in each of these circumstances.
(Chartered Accountants).

[*Hints* : (a) Directors' opinion is wrong. Group Accounts must deal with the Accounts of Subsidiaries.

(b) Unaudited Accounts of Foreign Subsidiaries should not be accepted.]

19. To what extent should the Auditor of a limited company have regard in the course of his Audit to events which have occurred subsequent to the date of the company's Balance Sheet ?
(M. Com.)

[*Hints* : The Auditor should pay particular attention to the following :—

(a) In case of closing stock whose estimated sale value has been credited to the Profit and Loss Account, the actual amount realised subsequently therefrom.

(b) In case of contingent liability whether the liability has subsequently been incurred.

(c) In case of closing stock valuation at Market price whether subsequent market price has decreased.

(d) In case of a Provision whether actual Provision is adequate.

(e) In case of Taxation liability whether actual Assessment Order is adequate.

(f) To see whether the Balance Sheet is drawn in accordance with the latest Amendment of the Companies Act, 1956.]

20. Under the Indian Companies Act, a Profit and Loss Account is to accompany each Balance Sheet to be placed at the Annual General Meeting, the idea being to give shareholders an opportunity to study the financial position of the company. State if this purpose is fully served by the above procedure. If not, explain the reasons. (B. Com.)

[*Hints* : If the Profit and Loss Account is drawn up in accordance with the latest Provisions of the Companies Act, disclosing all the details, and if the Books of Accounts, from the records of which the Final Accounts have been drawn up, are shorn of errors and inaccuracies, this purpose will be served.]

CHAPTER VIII

VALUATION AND VERIFICATION OF ASSETS AND LIABILITIES

Meaning of the terms 'Valuation' and 'Verification'

By Valuation is meant the ascertainment of money value at which the assets and the liabilities are to be shown on the face of the Balance Sheet. Verification, on the other hand, means the proof of existence of the Assets and the liabilities on a particular date, viz., the date of the Balance Sheet.

Valuation of Fixed Assets

Fixed Assets are those which are acquired and held for continuous service being rendered over a long period of time. They are not meant for resale and may be put to repeated uses. Land & Building, Plant & Machinery, Furniture & Fittings, and Motor Cars & Vans are assets of this nature. Such assets should be valued at Original Cost *less* accumulated Depreciation up to the *date* of valuation. The valuation of 'Goodwill' is somewhat complicated. Goodwill means the reputation or good name of a business. Different methods are followed in valuing Goodwill. Sometimes it is assessed at *so many years' purchase of the average profits* made by a concern during the past several years. Another method is to base Goodwill on *Super-Profits.* By Super-Profits should be meant profits earned by a business in excess of a reasonable return on the amount of Capital invested in business elsewhere. A third method is to Capitalise the average annual *super-profits.*

Valuation of Floating Assets

Floating Assets are such assets as cannot be put to repeated uses. They are held for a temporary period, and by one single use they go out of existence. For instance, if Cash is once spent, it is no longer there. If money is once realised from a Debtor, it is no further an asset. Stock-in-trade, Investments, Stores, Bills Receivable, Book Debts, etc., are assets of Floating nature. These may also be called Current or Liquid Assets. Different principles are to be followed in valuing different Floating

Assets. *The question of valuation does not arise in the case of* Cash in Hand *or* Cash at Bank. *Bills* Receivable are to be valued at the price at which they can be discounted at the market rate of discount. Investments should be valued at Cost (* Market price of the Investments are to be shown by way of a Note on the Balance Sheet). The valuation of Stores will be at cost. The Stock-in-trade (Closing Stock) ought to be valued at Cost or at Market Price prevailing on the date of valuation, whichever is lower. Work-in-Progress (i.e., partly finished or semi-manufactured goods) has to be valued at Prime Cost, comprising (i) Direct Materials, (ii) Direct Labour and (iii) other Chargeable Expenses. Verification, which means establishing proof of the existence of an Asset or a Liability, is to be conducted on the very date of Balance Sheet. If it is done at an earlier or later date, the Auditor cannot be fully satisfied as to whether the Asset or the Liability concerned was exactly of that amount on the Balance Sheet date.

Date of Verification

The verification of *Goodwill* shall be done by reference to the Agreement between the concern and the vendors in case of change of ownership of the business. In other cases, the Resolution passed by the Management creating the Goodwill should be examined. *Land & Buildings* will be verified on the basis of the Title Deed or the Deed of Conveyance in which must appear the name of the owner. The stamp of the office of the Sub-Registrar with the date and his signature has to be there on this Deed. For *Plant & Machinery, Furniture & Fittings* and *Motor Cars & Vans,* the Auditor should obtain a certified Statement from the Management and with the help of experts he should make a physical verification. As the Auditor cannot be expected to be conversant with the technicalities of Machinery & Plant, he has to rely on experts in the matter. *Patents, Trade Marks* and *Designs* should be verified with relevant Documents.

Verification of Fixed Assets

A certified List of *Investments* belonging to the concern under Audit should be procured from those in Management. The

* The Market Price is obtainable from the Official Lists published by the Stock Exchange in cases of 'Quoted' Investments.

Securities are to be personally inspected by the Auditor with reference to this List. He should see that the name of his client appears as the last named person on the Security. To verify the existence of Assets like *Stores and Spare Parts, Loose Tools, Stock-in-trade and Work-in-Progress,* from a responsible Official a Certificate must be obtained to the effect that on the Balance Sheet date the Assets were personally inspected by the signatory of the Certificate and that these are in the absolute possession and ownership of the business. Wherever possible, the Auditor should make a personal inspection himself. For the item *Sundry Debtors* or *Book Debts,* the Auditor would do well to instruct his client that the Debtors be advised to send directly to the Auditor a confirmation of the balances owing by them on the Balance Sheet date. If it is the case of a Joint Stock Company, the item 'Sundry Debtors' is to be shown on the Balance Sheet grouped under two heads : (a) Debts outstanding for over six months and (b) other Debts (i.e., debts of less than six months' standing). Here, too, verification should be done from confirmation of balances and also from Bill Register in which the dates of sending Bills to Sundry Debtors and the dates of realisation are indicated with reference to the Cash Book. Each record on the Bill Register should bear the signature of some responsible official. *Cash in Hand* should be verified through personal counting by the Auditor. *Cash at Bank* should be verified from the Certificate obtained from the Banker. The Bank Pass Book and the Bank Reconciliation Statement prepared by the client must be taken into consultation for Bank Balance verification. As in the case of Sundry Debtors, *Loans & Advances* also should be verified by confirmation of Balances from parties. Persons doing Import/Export business have money deposited with the Customs or Port Trust Authorities. These Balances are to be verified from certificates got from the Authorities concerned and their respective Pass Book. For verifying the *Bills Receivable,* personal inspection of the Instruments along with the Bills Receivable Book has to be done. It should be seen whether all Bills due have been accounted for.

Verification of Floating Assets

Prepaid Expenses (e.g., Unexpired Insurance, Deferred Advertisement, etc.) and *Incomes Earned but not Received* (e.g., Accrued Rent, Interest, Dividend, &c.) are to be verified with supporting vouchers and relevant documents. On a Company Balance Sheet will appear a heading *Miscellaneous Expenditure and Losses.* The items of this heading will include (i) Preliminary Expenses, i.e., expenses incurred during the stage of company formation (this item to be verified with the resolution passed by the Board of Directors) ; (ii) Expenses including Commission or Brokerage on underwriting or subscription of Shares or Debentures (this item to be verified with the Agreement between the company and the share brokers or underwriters); (iii) Discount allowed on the issue of Shares or Debentures (to be verified with the Board Meeting Resolution); (iv) Interest paid out of Capital during construction, stating the rate of interest (to be verified with the Board Resolution and the Sanction obtained from the Central Government in this connection) ; (v) Debit balance of Profit and Loss Account to be shown only if there is no General Reserve from which it can be deducted (to be verified with the Profit and Loss Account and the Directors' Report to the Shareholders in which the profit position of the company is fully explained).

The *Capital* of a Sole Trader may be verified with the Cash Book and the Bank Pass Book of the business ; for, the introduction of Capital is usually in cash. If Capital contribution has been in kind (for instance, in stock), entry in the Journal is to be taken into examination. It has to be borne in mind that the annual trading results alter the volume of Capital where it is not fixed. Capital will be increased in case of Profit and it will be reduced by Drawings and Loss. So, the Annual Accounts are to be scrutinized for Capital verification. In case of a Partnership, the Partnership Agreement (generally embodied in Partnership Deed or Articles of Partnership) should be examined for verification of Partners' Capitals. Here, too, the Annual Accounts are to be looked into. A distinction between *Fixed Capital* and *Floating Capital* is of importance. Where Capital is fixed, the original amount contributed remains unaltered and the profits are withdrawn through a separate account styled as

Verification of Fixed Liabilities

Current Account. Where Capital is floating, the trading results, Profit or Loss, will either increase the volume of Capital or will decrease it. In the case of a Joint Stock Company, the *Authorised Capital* is to be verified from the Memorandum of Association and the Articles of Association. The *Subscribed Capital* will be verified from the Letters of Application submitted by prospective shareholders and from the Share Application and Allotment Book duly signed by the Chairman of the Board of Directors. The Directors' Minute Book should also be consulted for verifying Allotments and Calls. The Shareholders' Cash Book and the Members' Register (Shareholders' Register) will also serve as guide in this connection. In order to verify Subscribed Capital *not paid up in cash* (Shares are sometimes issued for consideration other than cash—for instance, when a company purchases a running business, to the vendors may be issued fully paid up Shares of the company), the Agreement between the Company and the party to whom Shares were allotted is to be inspected. Bonus Shares issued as fully paid up to the existing Shareholders are also shown under *Subscribed Capital* separately as should be the case for Shares issued to vendors also. The verification of that part of the Subscribed Capital which covers Bonus Shares should be done with the Directors' Resolution recommending the issue of such Shares and the Shareholders' Resolution at the Annual General Meeting ratifying the Directors' recommendation. In this connection the Central Government's permission to issue Bonus Shares should also be seen. In case of Forfeiture of Shares and their subsequent Re-issue, the Directors' Resolutions passed in this connection are to be examined. For verifying the *Reserves and Surplus* appearing on a Company Balance Sheet, the things to be examined are : Directors' Minutes Book, Directors' Annual Report and the Appropriation portion of the Annual Profit & Loss Account. For a business of non-Company type, the Profit & Loss Account will be the guide. To verify the item *Loan,* the Agreement with the party advancing the Loan should be carefully seen. In the case of a Joint Stock Company, *Loans* are to be shown on the Balance Sheet under two heads : *Secured Loan* and *Unsecured Loan.* The former is supported by Securities or mortgages and the latter not so supported. To verify *Secured Loan,* the Receipt of the Securities lodged or copy of the

Mortgage Deed and the Mortgage Register should be asked for and the correspondence in connection with contracting of the Loan between the Company and the party should be taken into examination. *For Unsecured Loan,* the Agreement and the Correspondence, if any, will be the evidence.

To verify the item *Bank Overdraft,* the conditions under which the Overdraft was allowed should be studied. The things to come under special examination will be : Cash Book (Bank column) entries ; the Bank Reconciliation Statement ; the Letter of Hypothecation ; the correspondence with the Bank and the Receipt of the Bank for the Securities lodged with it. To verify the item *Bills Payable,* the Bill Register is to be consulted. The Drawers of the Bills may be contacted through correspondence or otherwise, where required. One of the most important items for verification on the Liabilities side of the Balance Sheet is *Sundry Creditors.* A certified schedule or list of all the creditors on open accounts on the date of the Balance Sheet should be obtained from the Management and the list is to be checked along with the Sundry Creditors' Ledger, if any, or with entries in the personal accounts of the General Ledger. Where transactions are numerous, a separate Ledger for the Sundry Creditors is desired to be maintained. The best way of verifying liabilities on account of Sundry Creditors is to scrutinize the payment vouchers for at least three consecutive months after the financial closing to see that the parties' bills were submitted within the financial period and payments done afterwards. As in the case of Sundry Debtors, here, too, the Auditor should insist on a practice like this. The client is to send to the creditors a Statement of amount due to them on the date of the Balance Sheet for confirmation. The confirmed Statement should be forwarded by the creditors direct to the Auditor. A common and important item on the Liabilities side is *Provision for Taxation.* To verify this item, the Auditor should ask for a schedule of the amounts provided for taxation. This schedule is to be checked up along with the Profit & Loss Account. It has to be seen that the provision made is not in any way inadequate. By going through the Assessment File, the Auditor should study the trend of past assessments. To verify the item

Verification of Floating Liabilities

Proposed Dividend appearing on the Liabilities side of a Company Balance Sheet, the Directors' Report, the Directors' Resolution recommending the dividend and the Profit & Loss Appropriation Account should be examined. The Auditor should also make it a point to see afterwards, when the Annual General Meeting would be over, the Shareholders' Resolution passing the Dividend. For verification of another item *Unclaimed Dividend* appearing on a Company Balance Sheet, a Certified List of Dividends declared but not claimed should be obtained from the Management. This has to be checked up along with the Dividend Register and copies of Dividend Warrants. It is advisable at the time of every Annual Audit to insist the client on their sending Reminders to the Shareholders not filing claim for Dividend. This is to guard against ghost parties being made to claim the Dividend. Where separate Bank Accounts are maintained for payment of Dividends, it should be seen that there is money at the Account just equivalent to the figure of Unclaimed Dividends. And this is to be ascertained from the Cash Book and the Banker's Certificate. In case of discrepancy, a Reconciliation Statement should be obtained from the client and that checked up with the Pass Book. *Creditors for Expenses*, e.g., Outstanding Rent, Outstanding Salaries & Wages, Outstanding Printing & Stationery, etc., is a common item on the Liabilities side of a Balance Sheet. To verify the item the Auditor should examine the relevant vouchers, such as the Landlord's Rent Bill, Salaries & Wages Book, etc. Also from the Management should be got a Certified list of the Expenses incurred during the period but not paid for by the date of the Balance Sheet. In the form of a foot-note appears on the Balance Sheet what is called *Contingent Liabilities not provided for in the Accounts.* Contingent Liability is that liability which may occur to the company on the happening of certain events. Claims filed against but not yet admitted by the company, Arrears of Dividends on Cumulative Preference Shares and outstandings on Capital Commitments (Liability on account of Purchase of Capital Goods like Machinery on Forward Contract) not paid for during the financial period are among the matters to come under this Head. To verify the Arrear Dividend on Cumulative Preference Shares, the previous Profit & Loss Appropriation Accounts and the Articles of Association of the Company

should be inspected. In other cases of Contingent Liability the correspondence between the company and the parties concerned should be the basis for verification.

Certain Case Laws

In connection with the verification and valuation of Assets and Liabilities, the Auditor would do well to study the decision of the Court in some of the English and Indian cases. These are :

(i) London Oil Storage Co. *v.* Seear Hasluck & Co. (England) ;

(ii) Kingston Cotton Mill Co., Ltd., *in re* (England) ;

(iii) Westminster Road Construction & Engineering Co., Ltd., *in re* (England) ;

(iv) McKesson *v.* Robins (U.S.A.) ;

(v) G. M. Oka, *in re* (India) ; and

(vi) The Registrar of Companies, Bombay *v.* P.M. Hedge (India).

The above named cases have been discussed in a subsequent chapter entitled "The Legal Status of an Auditor and his Liability" (Chapter XIV).

QUESTIONS ON CHAPTER VIII

1. (a) Discuss the terms 'valuation' and 'verification' of assets from an Auditor's point of view.

(b) How would you verify the following ?—

(i) Freehold Property ;

(ii) Loan on Mortgage ; and

(iii) Copyright. (B. Com.)

[*Hints* : (i) Freehold Property should be verified by reference to the Title Deed and by personal inspection.

(ii) Loan on Mortgage should be verified by inspection of the Mortgage Deed and correspondence with the Mortgagee.

(iii) Copyright should be verified by examining the Copyright Agreement.]

2. "An Auditor is not a valuer, but he is intimately connected with values." Discuss.

(M. Com.)

[*Hints* : What is hinted at by the Statement is that an Auditor cannot be expected to be an expert in the matter of valuing the assets or the liabilities of his client, he having but little technical knowledge as to the things to be valued. The Auditor must, however, satisfy himself that the valuation has been done by an expert valuer and that there has been neither overvaluation nor undervaluation judged from the standpoint of prudence. An Auditor, therefore, has to connect himself closely with the question of value ascertainment.]

3. "An Auditor is not a valuer." "An Auditor is intimately concerned with values." Explain fully how these two statements can be reconciled. (M. Com.)

[*Hints* : Auditor should not himself value the trading goods, especially the Engineering Materials that would be exhibited on the Balance Sheet as an asset, but he should check up the valuation from records available.]

4. How and in what way does verification of assets and liabilities differ from vouching ? How would you verify the following ?—Stock-in-trade, Investments and Bills Receivable.

(M. Com.)

[*Hints* : *Vouching* indicates establishing the authenticity of a transaction by reference to supporting documents, called vouchers. Verification, on the other hand, aims at being satisfied about the fact that an asset or a liability is actually in existence. It is possible that an asset was acquired quite all right, some time during the accounting year or in some preceding year, but that has been misappropriated afterwards. To detect such misappropriation, a verification has to be conducted, either through personal inspection by the Auditor or otherwise, where permissible.]

5. Why is verification of assets and liabilities done in addition to vouching ? What precisely is the scope of verification ?

How would you verify the following assets :—Investments, Book Debts, Goodwill, Leasehold Mining rights ? (B. Com.)

[*Hints* : Vouching is conducted for establishing the authenticity of a transaction, whereas Verification is done for checking the physical existence of the Assets and Liabilities as on a particular date. Verification should be done in addition to vouching. For, an Asset or a Liability may disappear or undergo an alteration in amount after the original appearance in the Books

having been duly vouched. To find out and establish, by personal inspection or through documentary evidence, where allowable, that the Assets and Liabilities do exist on the date of the Balance Sheet at the figures incorporated in it lies within the precise scope of verification.

Investments are to be verified by personal inspection of the securities on Balance Sheet date with reference to the Investments Schedule obtained from the Management. Book Debts are to be verified from the Bill Register and from confirmation of Balances from Debtors. Goodwill should be verified from Agreements and correspondence with parties. Leasehold Mining Rights are to be verified from Lease Agreement and Register of Properties under Lease.]

6. (a) What part does verification of an asset play in the Auditing of a set of Books ?

(b) As the Auditor of a limited Company, how will you verify the undermentioned items ?—

(i) Bills Receivable ;

(ii) Investments ; and

(iii) Sundry Debtors. (B. Com.)

7. After vouching has been done to the satisfaction of the Auditor of a Public Limited Company, do you think it is necessary for him to consider the question of valuation and verification of Assets ? What consequence might follow if valuation and verification are not carried out by Auditors in respect of the assets appearing in the Balance Sheet to be certified ? (B. Com.)

[*Hints* : An Auditor, after completing the Balance Sheet Audit, has to certify that to the best of his knowledge and information, the Balance Sheet exhibits a true and fair view of the state of affairs of his client. This certificate would be of no importance, if the assets and the liabilities have not been valued correctly and if their presence has not been duly established through a course of scientific verification. If due care is not taken by the Auditor in the matter of valuing and verifying the Assets or the Liabilities, action may be brought against him. The following case decisions ought to be studied in this connection :

(i) London Oil Storage Co. *v.* Seear Hasluck & Co. (England),

(ii) McKesson *v.* Robins (U.S.A.),

(iii) Westminster Road Construction & Engineering Co., Ltd., *in re* (England),

(iv) G. M. Oka, *in re* (India), and

(v) The Registrar of Companies, Bombay *v.* P. M. Hedge (India).]

8. How would you treat appreciation and depreciation in the value of Investments in the case of a (i) Finance Company ; (ii) Insurance Company ; (iii) Trading Company ; (iv) Investment Trust Company in the Annual Balance Sheet ? (B. Com.)

[*Hints* : (i) Appreciation will be credited and Depreciation will be debited to the Profit and Loss Account and in the Annual Balance Sheet Investments will appear at the altered figure.

(ii) Profit and Loss Account will not be directly affected but in the case of a fall in Market Price, Investment Reserve may be created. Investments will appear at the original figure in the Balance Sheet.

(iii) Fluctuation of market value will not affect Profit & Loss Account and Investments will be shown at the unaltered figure.

(iv) Profit and Loss Account will be credited in the case of appreciation and debited in the case of depreciation. The Asset will appear in the Balance Sheet at the revalued figure.]

9. It has been stated that the valuation of an investment for Balance Sheet purposes depends largely upon the object for which the investments are held. Briefly discuss this statement.

(*Chartered Accountants*)

[*Hints* : Valuation of Investments should usually be done at *Cost.* If an Investment Corporation makes the purchase of Investments, and if the Book value is considerably higher than the Market value, on the Balance Sheet date the creation of an Investment Reserve by appropriation of Profits and utilisation of this Reserve for the purchase of New Investments may be recommended by the Directors to the Shareholders at the Annual General Meeting. Please also see hints on question 8.]

10. How would you verify the following assets ?—

(a) Cash in hand ;
(b) Government papers as securities ;
(c) Stock-in-trade , and
(d) Land and Building. (B. Com.)

[*Hints* : (a) By actual Count of Cash on Balance Sheet date. (b) By personal inspection. (c) By physical count or measurement. (d) By examining the Title Deed.]

11. In the course of your Audit of the Balance Sheet of a Company what steps would you take to verify (a) the Cash in hand and (b) the Balance at Bank ? Take into account (i) the fact that some of the Cash in Hand consists of cash in the hands of the Manager and (ii) the possibility that a false Bank Pass Book (obtained in collusion with a Bank employee) may be placed before you. (B. Com.)

[*Hints* : (a) Cash will be counted on Balance Sheet date by the Auditor.

(b) Bank Manager's Certificate supported by Bank Reconciliation Statement will be called for.

(c) In case of Cash with Manager, a certificate must be obtained from the Manager and cash should also be counted personally by the Auditor.

(d) All the entries in the Cash Book will be checked by the Auditor who, for this purpose, will go to the Bank and examine the ledger account of the client maintained by the Bank.]

12. In Auditing the Books and Accounts of a manufacturing company explain how you would verify the valuation of the following items :—(a) Work in-progress ; (b) Sundry Creditors ; (c) Disposal of Plant ; (d) Bad Debts. (B. Com.)

[*Hints* : (a) A certificate from the Management along with the Production Statements has to be obtained. During scrutiny of the Production Statements, it should be seen that only Prime Cost has been included in the valuation of Work-in-Progress.

(b) All the Payment Vouchers subsequent to the date of financial closing should be seen. The entries in the Purchases Book, especially those of the last month of the Accounting year, should also be examined to detect suppression of liabilities, if any.

(c) The Sold Note, the Receipt counterfoil and the Plant & Machinery Register should be examined.

(d) Bill Register and Correspondence with debtors are to be seen.]

13. What steps will you take before you can satisfy yourself that 'Sundry Debtors' in a Trader's Balance Sheet has been correctly stated ? (B. Com.)

[*Hints* : Confirmation of balances from Debtors must be seen. Bill Register should be scrutinized along with Sundry Debtors ledger by reference to the list of Sundry Debtors to be furnished by the Management.]

14. In the course of Auditing the Books of a client you come across the following :

(a) Stock Exchange Securities of a considerable amount are said to have been purchased but have not been taken delivery of up to the date of the Audit.

(b) A house is said to have been purchased in Calcutta but conveyance has not been completed.

(c) "Sundry Debtors" contains an item of Rs. 12,000 which has been recurring in three consecutive Balance Sheets.

(d) Office Premises worth about two lakhs of rupees has been so depreciated in the Books of Accounts as to show no balance at all.

Comment as an Auditor and explain the procedure you would adopt in each of the above cases before you can pass it.

(B. Com.)

[*Hints* : (a) The securities should be shown in the Balance Sheet. The correspondence done in this connection, the Broker's Bought Note and the payment cheque counterfoil should be seen.

(b) Building should be shown in the Balance Sheet with notes that conveyance is pending. The negotiations with the seller should be examined.

(c) Correspondence with Debtors is to be seen and in the absence of adequate reasons for deferring the payment, the amount should be shown as a Bad or irrecoverable Debt.

(d) The existence of a Secret Reserve should be mentioned in the Auditor's Report.]

15. Your client is a Stationer and his Sales, both cash and credit, are of considerable magnitude.

In course of your Audit you discover that some respectable parties, who are regular customers of your client, have denied liability with respect to some outstandings shown against them. How would you satisfy that the claims of the customers are correct, and in such a case how would you reconcile the discrepancies in the Accounts of your client ? (B. Com.)

[*Hints* : A detailed check of all the Cash Memos and Receipt counterfoils should be conducted along with the Cash Book and Sundry Debtors Ledger Accounts to see whether receipts from Customers are suppressed. This will reveal misappropriation of Cash. System of yearly

confirmation of Balances from Customers will be very useful.]

16. The following information has been obtained from the Books and Records of a large retail stores shop :—

On January 1, 1947, the total of Sundry Debtors (Dr.) was Rs. 67,000, and there was a total of credits (for Sundry Debtors) amounting to Rs. 500. The Sales for the year amounted to Rs. 8,53,000. The value of dishonoured bills and cheques was Rs. 2,000 and the total of discounts previously allowed but subsequently withdrawn was Rs. 35. The amount of Cash received from Debtors was Rs. 7,95,000 and total discount allowed was Rs. 28,000. Returns Inward amounted to Rs. 3,165 and Bills Receivable Rs. 41,000. The Bad Debts written off amounted to Rs. 1,535.

The amount of Total Debtors on December 31, 1947, as per the last Schedule of Debtors was Rs. 53,525 (Dr.) and Rs. 165 (Cr.).

Calculate the discrepancy in the Total Debtors' Account and explain how you would proceed to make a reconciliation.

(B. Com.)

(i)

[*Hints* : Dr. Total Debtors Account Cr.

1947		Rs.	1947		Rs.
Jan. 1	To Balance b/f.	67,000	Jan. 1	By Balance b/f.	500
Dec. 31	„ Sales	8,53,000	Dec. 31	„ Cash received	7,95,000
	„ Bills & Cheques dishonoured	2,000		„ Discounts allowed	28,000
	„ Discounts withdrawn	35		„ Returns Inward	3,165
	„ Balance c/d.	165		„ Bills Receivable	41,000
				„ Bad Debts w/off	1,535
				„ Balance c/d.	53,000
		Rs. 9,22,200			Rs. 9,22,200

If the closing credit balance of Rs. 165 is correct, there is discrepancy in the amount of closing debit balance. Instead of Rs. 53,325, the amount should be Rs. 53,000.

(ii)

Dr. Total Debtors Account Cr.

		Rs.			Rs.
1947			1947		
Jan. 1	To Balance b/f.	67,000	Jan. 1	By Balance b/f.	500
Dec. 31	" Sales	8,53,000	Dec. 31	" Cash received	7,95,000
	" Bills & Cheques dishonoured	2,000		" Discounts allowed	28,000
	" Discounts withdrawn	35		" Returns Inward	3,165
	" Balance c/d.	490		" Bills Receivable	41,000
				" Bad Debts w/off	1,535
				" Balance c/d.	53,325
		Rs. 9,22,525			Rs. 9,22,525

If the closing debit balance of Rs. 53,325 should be taken as correct, the closing credit balance as given in the data cannot be Rs. 165 ; from (ii) above, it has to be Rs. 490.

To locate the cause of the discrepancy, two things are to be done : *first,* the opening balances as at Jan. 1, 1947 should be checked with the closing balances as on the previous day, viz., Dec. 31, 1946 ; *secondly,* all the transactions with the customers done during the year 1947 should be thoroughly checked from the records appearing in the books of accounts by reference to the relevant vouchers.]

17. How would you value the following assets for the purpose of Balance Sheet ?—

Raw materials ; Finished goods ; Partly finished goods ; Goods manufactured for the execution of a contract. Your clients (a limited company) want to value goods produced during the year (but not sold) at the market price prevailing on the

date of the Balance Sheet (which is higher than the cost). Is *there any legal bar in doing so? Discuss.* *(M. Com.)*

[*Hints*: Raw Materials should be valued at Cost and finished goods should be valued at Cost or Market price, whichever is lower. Partly finished goods should be valued on the basis of Materials consumed and Direct Labour employed during the course of manufacture. Goods manufactured for the execution of a Contract should be valued at Cost with additional Cost expected to be incurred on those goods. If the valuation is only on the basis of the Cost already incurred, the contractee will get information of the very high margin of profit. According to the Companies Act for the compilation of a Company Balance Sheet unsold goods must not be valued at Market Price when it is higher than the Cost.]

18. Set out the procedure that should be followed by an Auditor in verifying the investments of a limited Company.

(M. Com.)

[*Hints*. On the Balance Sheet date the Auditor should visit the Registered Office of the Company and obtain a Certified List of Investments from the Secretary. With this list he will personally inspect all the Investments and see that they belong to the Company. He will also verify the List with the Investment Register.]

19 In Auditing the accounts of a business, how would you verify the following assets?—

(a) Motor Delivery Van of a Dairy Company.
(b) Leasehold Property of a Colliery.
(c) Crockery and Cutlery of a Restaurant business.
(d) Copyright of a Publishing firm. (B. Com.)

[*Hints*: (a) Vans should be personally inspected by the Auditor with reference to the certified list of vans.

(b) Leasehold Property should be verified with the Lease Agreement. The inventory or Register of Property held by the lessee should also be inspected.

(c) Crockery and Cutlery should be verified, by personal inspection, with the Certified List of Crockery.

(d) Copyright should be verified by reference to the Agreement between the Authors and the Publishing firm.]

20. How would you verify the following assets and liabilities of a Company ?—

(a) Investments in paper securities ;
(b) Forfeited shares ;
(c) Contingent Liability ;
(d) Bad and Doubtful Debts ;
(e) Cash-in-transit from Branches. (B. Com.)

[*Hints* : (a) See hints to Q. 5 and Q. 18.

(b) Forfeited Shares are to be verified with (i) Directors' Resolution appearing in the Directors' Minutes Book and (ii) entries in the Members' Register. The Auditor is to inquire whether, prior to forfeiture, due Notice was sent to the defaulting Shareholders.

(c) Contingent Liabilities are to be verified with the Company's correspondence with parties and the schedule of such Liabilities certified by a responsible official.

(d) Bad and Doubtful Debts are to be verified with the Bill Register and Correspondence between the company and its Sundry Debtors.

(e) Cash-in-transit is to be verified from (i) Branch Statements, or (ii) the advices from agents]

21. Write a short note on the valuation of uncompleted contracts, particularly dealing with the question of anticipated profit or loss on the jobs concerned. (B. Com.)

[*Hints* : Uncompleted Contracts are to be valued at cost and any anticipated expenses to be incurred should also be included in the valuation. Any loss on the jobs apprehended to be incurred may be provided for in the Profit & Loss Account. But expected gain should not be taken into account, on a conservative basis. Sometimes this basis is ignored and anticipated profit is taken credit of in the Accounts.]

22. (a) What are the points to be considered before an outstanding debt may be treated as a bad debt ?

(b) A sum of money has been outstanding against a purchaser of goods for a long time, and there is very little hope of recovery. It has been decided to write it off as bad What should be the difference in Accountancy treatment if a part of this money is suddenly recovered (i) before or (ii) after the debt has been actually written off as bad ? (B. Com.)

[*Hints* : (a) The Bill Register should be seen to verify the date when the Bill was issued to the Debtor. The correspondence with the Debtor concerned should be examined to find that the debt is irrecoverable.

(b) (i) If part of the amount is received before Annual closing, the total amount of the Provision for Bad and Doubtful Debts should accordingly be reduced.

(ii) If part of the amount is recovered after the debt has actually been written off in the Accounts, this amount will be credited to the Profit and Loss Account of the next period with the narration "Amount Received which was considered bad in the Previous year". Moneys recovered in this way are known as Bad Debt Dividend.]

23. How would you verify the following items on a Balance Sheet ?—Bills Receivable, Advances for value to be received, Goods in transit, Machinery purchased under Hire-Purchase arrangement. (B. Com.)

[*Hints* : (i) Bills Receivable will be verified with the Bill Book and Bank Statements. If the Bills Receivable are waiting for being discounted, personal inspection is recommended.

(ii) Advances for value to be received should be verified from parties' Receipts and subsequent challans and records.

(iii) Goods-in-transit will be verified from challans and other documents forwarding the goods. The documentary evidence of the subsequent receipt of these goods should also be inspected.

(iv) The actual Hire-Purchase Agreement and correspondence with the vendor should be examined. The Auditor should also personally inspect the Machinery and see the vouchers for the payment of the instalments.]

24. State fully the steps you will take to satisfy yourself about the closing Stock-in-trade of a manufacturing concern when you are conducting its Audit as a Statutory Auditor. (B. Com.)

[*Hints* : Three Case Laws may be referred to, viz., *in re* Kingston Cotton Mill Co., Ltd. (England), *in re* Westminster Road Construction and Engineering Co., Ltd. (England) and McKesson *v.* Robins (U.S.A.).]

25. State what you know of the facts and judgement of a decided case bearing upon the duties of an Auditor in regard to stock. (B. Com.)

[*Hints* : Physical inspection of Stock should be done by the Auditor on the Balance Sheet date. For cases, see hints on Question 24.]

26. What cardinal principle should be followed in regard to valuation of Closing Stock, and why ?

What is meant by a Stock Exchange Security ? In course of your Audit you find that your client has purchased a considerable amount of these securities. What procedure would you adopt for a proper valuation in the Balance Sheet ? Would it make any difference if your client were (a) a Timber Merchant *or* (b) an Investment Trust ? (B. Com.)

[*Hints* : Closing Stock should be valued at Cost or Market price whichever is lower If the Stock is valued at Cost when the Market Price is lower the Gross Profit will be increased, because when that Stock is sold it will fetch less price than what is taken in the Accounts. By Stock Exchange Security should be meant such Securities as are readily bought and sold in the Stock Exchange and quoted in the Stock Exchange Gazette When these securities are purchased the Auditor should see the Bought Notes of the Stock Exchange Broker and Compare the Purchase Price with the Quotation of the Stock Exchange Gazette on the date of purchase.

(i) These Securities should be valued at cost in the case of a Timber Merchant.

(ii) In the case of an Investment Trust, these Securities should be valued at cost or market price whichever is lower.]

27. In each of the following cases explain in what circumstances you as an Auditor would accept the valuation of an inventory which has for many years been consistently prepared on one or other of the following bases and certified by the Management :—

(a) Cost Price ; (b) Market Price ; (c) Cost or Market Price whichever is lower ; (d) Sales Value ; (e) Standard Cost.

(B. Com.)

[*Hints : Inventory means 'a detailed list of goods &c.' The Auditor should mention in the Balance Sheet the basis of the Valuation of Closing Stock indicating that such* Stock should always be valued at Cost or Market Price whichever is lower.

(a) Cost Price will be accepted when the Market Price is higher.

(b) Market Price will be accepted when Cost is higher.

(c) This will be accepted.

(d) If Sales Value is lower than Cost Price, it will be accepted.

(e) If Standard Cost is lower than Market Price, it will be accepted.]

28. (a) 'Stock presents one of an Auditor's greatest difficulties.'—Examine the statement fully.

(b) What are the duties of an Auditor in relation to Stock-in-trade ? (B. Com.)

[*Hints :* The Auditor is beset with great difficulty in respect of the verification and valuation of the item 'Stock-in-trade' partly because of his lack of technical knowledge about goods dealt in in his client's concern and partly for the conflicting case decisions springing from Courts of Law. Whatever may be the difficulty, the Auditor has to follow the cardinal principle regarding stock valuation as laid down earlier.]

29. Write a short essay dealing with the Auditor's duty in connection with Stock-in-trade, referring to leading cases in the matter. (M. Com.)

[*Hints :* The Auditor should get a Certified Inventory from the Management and personally inspect Stock on Balance Sheet date. For *cases* please refer to Question 24.]

30. The item "Stock" in the Balance Sheet is often described as—"Stock-in-trade—at cost, Rs. . . . . (As taken, valued and certified by the Management)". Explain the implications of the expression used and state to what extent can an Auditor do away with the checking of the stock figure stated with above expression. (M. Com.)

[*Hints :* Stock should not be described as "Stock-in-Trade at Cost". "Stock-in-trade at Cost or Market Price whichever is lower" should be the correct description. The Auditor shoud check in detail the valuation, with necessary records.]

31. State what you consider to be the duty of an Auditor in relation to Stock-in-trade. (M. Com.)

[See hints on the preceding questions on 'Stock-in-trade'.]

32. The cost price of the closing balance of the stock-in-trade is Rs. 1,80,500.

The stock consists entirely of imported goods which are highly in demand and the import of which has been stopped for the next year. From all such considerations it is very likely that the stock will easily sell at 200% over the cost price. Is there any harm in putting up the value of the stock at Rs. 2,00,000 ?

Give full and careful reasons for your answer. (B. Com.)

[*Hints* : The Closing Stock Valued at Cost of Rs. 1,80,500 should not be valued at Rs. 2,00,000 in spite of the fact that Import of such goods has been stopped and that the goods are expected to be sold at a much higher rate than now. Valuation should always be done at Cost or at below Cost. A foot-note may, however, be inserted in the Profit and Loss Account, stating the expected rise in price.]

33. Stock-in-trade is usually valued on the basis of 'the lower of cost and market value'. Describe how 'cost' and 'market value' are normally ascertai d.

(Chartered Accountants)

[*Hints* : Cost is ascertained from Original Invoices and relative documents of Purchaser. Market Price is ascertained from Quotations of Sale Price of such goods and sale records of the goods. For a concern that deals in investments like Shares, Debentures, Government Papers, &c., the Market Price is ascertained from Quotations of the Stock Exchange Gazette or from the journal 'Capital' near about Balance Sheet date. For Jute and Gunny Prices Quotations of ' Thomas & Co. should be consulted.]

34. "An Auditor is a watch dog, but not a bloodhound." Explain. (B. Com.)

[*Hints* : This remark was made by the Judge at the time of delivering Judgment in the Kingston Cotton Mill case of England. He was of opinion that the Auditor, in the absence of suspicious circumstances, was not bound to inspect Closing Stock on the Balance Sheet date. This decision was however reversed in McKesson & Robins case of U.S.A.]

35. What are the duties of an Auditor in relation to the following : (i) Stock-in-trade of a manufacturer, and (ii) Work-in-Progress of a contractor ? What points will receive your serious consideration before you allow the annual profits or any portion thereof to be included in the valuation of the asset 'Work-in-progress' in the books of a contractor ? (B. Com.)

[*Hints* : (i) Stock-in-trade Cost records should be examined with Market rates. The Stock valuation must be certified by the Management and the Auditor should personally inspect such stock with the list furnished by somebody in authority on the Balance Sheet date.

(ii) Certified List of Work-in progress should be obtained by the Auditor and he will examine the Work-in-Progress with certified Production Statements from the Works Manager. The Auditor should check in detail the Prime Cost of Labour and Materials to see that valuation has been done at Direct Cost. By way of 'test check' he should personally inspect at the Workshop some of the items of Work-in-Progress. Building Contractors' Work-in Progress should be verified with the Surveyor's Certificate in respect of the job already done.]

36. What certificates you, as an Auditor, normally take from your clients, their officers, or from third Parties ? To what extent, if any, would you be entitled to rely on them ? Discuss Case Laws, if any, on the subject. (M. Com.)

[*Hints* : The Auditor normally takes Certificates from the clients for Closing Stock. Cash and Bank Balances and Investments. Before placing reliance on the Certificates, the Auditor should see whether they come from very responsible and tried officials of the concern and whether there is any ground for being suspicious. As far as practicable personal inspection and communication with parties concerned should be done. For Trade Debtors & Creditors and Loans & Advances, confirmation of Balances from parties should be called for. If the Investments are with the Bank, the Banker's certificate should be obtained for the Auditor's perusal.]

37. How would you define Goodwill and how should it be valued for Balance Sheet purposes ? (M. Com.)

38. You are required to set out the steps you would, as Auditor, take in order to satisfy yourself that (i) Stock had not

been overvalued, (ii) Book Debts had not been overvalued, and (iii) Trade Liabilities had not been understated. (B. Com.)

[*Hints* : (i) Stock Valuation should be checked with Cost records and Market Quotations to see that Stock is valued at Cost or under.

(ii) Book Debts are to be checked with the Bill Register and Confirmation of Balances from Debtors and Sales Records.

(iii) Trade Liabilities should be checked with Purchases Book, Invoices and Payment Vouchers of three subsequent months after the Balance Sheet date.]

39. State briefly the manner of verification of the following items in the Balance Sheet of a Company :—

(i) Certified Investments.
(ii) Work-in-progress.
(iii) Bills Receivable.

(Chartered Accountants)

[*Hints* : (i) Certified Investment list should be obtained from the Management and the Auditor should personally see the investments and the Investment Register.

(ii) Please see hints on Question 35.

(iii) Bills Receivable should be verified with the Bills Receivable Day Book and Bank Statements and if any Bills are lying with the Clients on Balance Sheet date undiscounted they should be inspected personally by the Auditor.]

CHAPTER IX

DEPRECIATION

Meaning of the term 'Depreciation'

Depreciation may be defined as a loss in the use value of an Asset. Every Asset undergoes this loss whether it is put to use or not. The value to be derived from the use of a new possession will be having a gradual shrinkage as the acquired asset gets old and older. The cause of the shrinkage in value is wear and tear, passage of time, obsolescence, etc.

Necessity of providing for Depreciation

Before the trading results are found out, the loss on account of Depreciation of the different Assets owned by an establishment must be povided for. If it is not done, the true results will not be ascertained and a case of inflated profits will arise. The necessity of providing for Depreciation is also there for replacing the old, worn out or obsolete Plant and Machinery or Building. Right from the beginning of the acquiring of an Asset, an amount should be set aside every year against the profits. The amount thus taken away from the profits should be made to be accumulated and be available at the time of replacement.

Different methods are followed for charging Depreciation. The method to be applied will depend on the nature of the Asset. A system known as **Straight Line Method** prescribes that at the end of each year a fixed amount will be charged by way of Depreciation so that the Asset comes to nil value, being rendered useless at the end of a specified period of time. For example, a Plant is bought for Rs. 10,000 and its life time is estimated to be 10 years. If a sum of Rs. 1,000 is written off every year, at the end of the 10th year, the Plant comes to zero value. The method is very simple and hence, the name Straight Line Method. It also goes by the name of Fixed Instalment system, as the amount of Depreciation provided for each year is one and the same. **Reducing Instalment System** of providing for Depreciation may be followed for Assets whose

life-time is long. According to this system, a fixed percentage on the diminishing balance will be written off each year. For instance, if 10% is to be written off as Depreciation on an Asset costing Rs. 10,000, at the end of the first year the amount of Depreciation will be Rs. 1,000. But in the subsequent years the amount of Depreciation will gradually diminish. At the end of the second year it will be Rs. 900 [10% on (Rs. 10,000 *minus* Rs. 1,000)], at the end of the third year Rs. 810 [10% on (Rs. 9,000 *minus* Rs. 900)], at the end of the fourth year Rs. 729 [10% on (Rs. 8,100 *minus* Rs. 810)] and so on. At the end of the estimated working life of the Asset, a scrap value will be arrived at. A prominent distinction between the above two methods is that under the *Fixed Instalment System* (or *Straight Line Method*) the same amount is charged against the Profits each year, whereas the amount charged as Depreciation under the *Reducing Instalment System* will be larger in the earlier years and smaller in the later years. And as such, the latter method may be recommended for such Assets as require heavy repairs when they are old. For then, there would be a balance between 'Depreciation' charges and 'Repairs' charges. In the first few years the amount of Depreciation is high but Repairs negligible. The reverse would be the case in the succeeding years. So, charges against the Profits will be of an even nature throughout the period the Asset gives service.

Depreciation Fund Method is sometimes followed. The characteristics of the method are that the Asset would appear on the Assets side of the Balance Sheet at Cost Price always and on the Liabilities side would appear a Depreciation Fund Account balance. According to the method under review, at the year-end, Profit & Loss Account is to be debited by a certain amount (same every year) of Depreciation and correspondingly Depreciation Fund Account to be credited. The credit balance of the Depreciation Fund Account will thus go on increasing with the passage of time and is to appear on the face of the Balance Sheet. Cash equal to the amount by which Profit & Loss Account is debited has to be kept outside the business in some good securities and that would accumulate at compound interest. The Investment will appear on the

Different Methods of Providing for Depreciation

Balance Sheet as Asset (Investment Account is to be debited and Cash Account credited when cash is taken out of the business). At the end of the life-time of the Asset, the Asset Account will be effaced by crediting this Account and debiting the Depreciation Fund Account. After the above entry, if the Asset Account leaves any debit balance or if the Depreciation Fund Account leaves any credit balance, that would be transferred to Profit and Loss Account. The Securities would be disposed of when it is time for replacement of the Asset and new Asset bought with the sale proceeds. The Depreciation amount should be fixed after consideration of the Replacement value assessed on the basis of probable inflation of price. The advantage of the method is that the amount required for replacing an Asset—and usually that is huge—is easily obtained without there being any drain on the Working Capital. But the difficulty lies in the fact that the market value of the Securities where money has been invested may go down at the time of replacement of the Asset and the sale proceeds may be insufficient for the purchase of a new Asset. To tide over this drawback, **Insurance Policy Method** is prescribed. According to this method, with an Insurance Company an Insurance Policy will be taken out for an amount just required for the replacement of an Asset. And entries are passed on the following lines. At the year-end, the Profit and Loss Account is debited by the amount of Annual Premium and the Depreciation Fund Account credited correspondingly. When premium is paid in cash, Cash Account is credited and Depreciation Fund Policy Account debited correspondingly. Thus, the Depreciation Fund Policy Account, having a debit balance will appear on the Balance Sheet as Asset and the Depreciation Fund Account, having a credit balance will appear as Liability. The term being over, as under the foregoing method, the Depreciation Fund Account and the Depreciation Fund Policy Account will both be closed, the former being debited and the latter credited. The Policy having matured, money will be had from the Insurance Company and that spent in the buying of the new Asset. Those that buy long leases with large capital outlay prefer to adopt **Annuity System.** The essence of the system is that Depreciation is to be written off as a loss not only on the Cost Price of an Asset but also on

the interest which the money spent in acquiring the Asset could earn if it was invested elsewhere. If a lease is acquired for 10 years for a sum of Rs. 50,000 in the Asset remains locked up not merely Rs. 50,000 but also the interest which this fifty thousand could have earned. So at a certain percentage interest will be added for one year to the debit balance of the Asset at the beginning of the year. The added value of the Asset will then be reduced by the requisite amount of Depreciation. The *Depreciation Annuity Tables* will say what the amount of Depreciation will be for a particular case where these things are given : the cost price, the rate of interest (Market Rate) and the estimated life-time of the Asset. The method should not be recommended where frequent changes are introduced to the volume of the Asset, that is, new additions are done and also old and worn-out pieces are sold. Complications in the calculation of Interest and Depreciation will then arise. In the case of certain Assets, the extent of loss due to Depreciation cannot be correctly known except on a fresh valuation of the Asset. So, a system of charging Depreciation known as **Revaluation Method** is followed for Assets like Live-stock (animals kept for use or profit), Loose Tools, Patents (grant of monopoly right to sell or prepare something invented by somebody), Copyrights, Patterns, etc. The life-time of these Assets is highly uncertain and to put them to revaluation by expert valuers is the only way of determining the amount of diminution in value. If the revalued amount of an Asset is *smaller* than the Book Value, the difference would be taken a Depreciation and be written off. But if the revalued figure i *larger* than the Book Value, the Appreciation, which is not a permanent gain, should not be brought into account. **Depletion Method** of providing for Depreciation is in practice for Assets which have a definite capacity of giving service A Salt Rock has a fixed deposit of salt in it and the owner of such Rock will write off as Depreciation the exact amount of salt removed from it during a period. The life of a Motor Vehicle is often calculated at so many thousand miles of run. At the end of a financial period, the miles run during the period under study will be the basis for charging Depreciation The method is impracticable in those cases where the exact amount of use cannot be measured and as

such an accurate record of depletion cannot be kept. **Machine-Hour Method** of calculating Depreciation is being applied in modern factories having extensive use of machinery. Under this system, the total Machine-Hours for which a machine will be expected to operate with efficiency are estimated beforehand through experts. The amount of Depreciation is calculated by dividing the total cost of the machine by the Total Machine Hours for which the machine would be working during the period under study.

Auditor's Duty in the matter of Depreciation

For the Auditor, it is not possible to estimate correctly the life-time of an Asset. So, a guess-work has to be done. But before that the question should be thought over from all sides. The Auditor should see that correct principles of charging Depreciation have been applied, the nature of the Asset having been taken into due regard. While checking up Depreciation, the Auditor must keep the *Income Tax Depreciation Schedule* ready for guidance. In the above schedule will be found different rates of charging Depreciation applicable to different Assets. The Auditor should also examine the Last Assessment File for finding the *Depreciation Statement* and the *written down value* of the Assets. The Auditor should also be satisfied that the amount of Depreciation for a period was fixed by some one in Authority. Whatever the Method, the Auditor's prime concern will be to look carefully into the adequacy or sufficiency of the amount charged as Depreciation for a certain period. If in his opinion the provision has been incorrect or if he suspects any foul play (the Directors may have inflated the Profits through the under-charging of Depreciation), the Auditor should unhesitatingly state in his Report that he is not satisfied as to the amount of Depreciation provided for. Before qualifying his Report, the Auditor should, however, discuss the matter at length with the Management. The question of qualifying the Report will arise only where the Management refuse to honour the views of the Auditor.

To make discussion on the topic of *Depreciation* complete, certain important Case Decisions arrived at in English Courts

may be narrated although they have no bearing on the present Companies Acts. (i) In **Lee v. Neuchatel Asphalte Company, Ltd. (1889)** the facts were as follows. The Company held a leasehold mine. One Mr. Lee on behalf of all the Ordinary Shareholders of the Company brought action for the purpose of getting an injunction to restrain the Directors from distributing Dividends to the Preference Shareholders until Depreciation of the Company's Wasting Assets would be provided for. There was a clause in the Articles of Association of the Company that the Directors need not make a provision for Depreciation of the Company's Assets. The Company provided Depreciation during some previous years but no such provision was made when profit was proposed to be distributed as dividend to the Preference Shareholders for the year under review. The decision of the court was that a Company having power from its Articles of Association could distribute dividends without providing any Depreciation on *Wasting Assets.* Had the case been instituted in a modern Court of Law the findings of the Court would have been different. The particular clause in the Articles referred to above would have been considered *ultra vires* ; for, the prescription of the present Companies Act in England as well as in India is that Depreciation must be provided for in the Profit & Loss Account on all Fixed Assets before any dividend could be declared. Where Depreciation has not been adequately provided for the true Profits cannot be revealed. And the Auditor cannot certify the Profit & Loss Account and the Balance Sheet as exhibiting a true and fair view of the state of affairs of the Company. (ii) In **Verner v. General and Commercial Investment Trust, Limited** (1894), the market price of the company's investments in Securities had gone down heavily. Without providing for this depreciation—when Market value was much lower than the Book Value of the Investments—the Company declared dividend. Question was raised as to the regularity of the dividend payment. The decision of the Court was in favour of the Management. It was held by the Court that subject to its Memorandum of Association and Articles of Association, a Trust Company, out of the excess of current income over current expenditure, could distribute a dividend

Leading Case Decisions

without providing for Depreciation. As has been observed in the previous case, the decision in a case like the present one, too, in a modern Court of Law would go on a different line. Today, the creation of an Investment Reserve is insisted upon, if the Market value of the Investments is at a much lower level than the Book value. Also it is demanded that fresh Securities be bought from out of the amount set apart from the divisible profits as *Investment Reserve.* (iii) In **Wilmer v. McNamara & Co., Ltd.** (1894) no Depreciation was provided for on Leases, Goodwill and Plant in the Profit and Loss Account of the year *under review. The Directors proposed to pay a dividend to the* Preference Shareholders out of profits. Mr. Wilmer, on behalf of the Ordinary Shareholders, moved to prevent the Directors from paying the dividend on the ground that without charging Depreciation on Fixed Assets dividend payment would be irregular. The Court decided that a Company could declare a dividend out of current profits without making any provision for Depreciation on Fixed Assets. The comment by the Authors on the case *Lee v. Neuchatel Asphalte Company, Ltd.* also applies here. (iv) **In Bond v. Barrow Haematite Steel Co., Ltd.** (1902), the fact was that the directors recommended the entire credit balance of Profit & Loss Account provisionally carried forward, to be transferred to Reserve, following the sanction of the Articles. It was found that as no depreciation had been charged on land, buildings, works, fixed plant and mining leases during the last few years, Capital got reduced. The Preference Shareholders claimed that their dividends should be paid out of the profits of the current year before making good such loss. The judgement was, however, that the Preference Shareholders could not compel the directors to declare a dividend in their favour without creating such reserves to make good the depreciation, as considered necessary by the directors who, in this case, acted being empowered by the Articles of Association to do so. (v) **In Crabtree, Thomas v. Crabtree** (1912), the fact was that the trustees were authorised by a * testator to carry on his business during the life-time of his wife on payment of the profits arising therefrom to her. The trustees *charged depreciation on the original cost of the fixed plant and*

* Testator—person who has left a (especially a particular) will.

machinery in addition to the cost of repairs before arriving at the profits. But the testator's wife claimed that such depreciation should be disallowed. The judgement was, however, passed in favour of the trustees. It was observed that where the machinery was necessary to perform the work of the business, *depreciation should essentially be charged.*

Company Auditor's duty in respect of provision for Depreciation

To decide the question of Depreciation charge, a Company Auditor should pay particular attention to the contents of Sections 205 & 350 of the Companies Act (latest) which are quoted here verbatim.

[1][205. (*1*) No dividends shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the Company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government :

Provided that—

(*a*) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960, it shall, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years ;

(*b*) if the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment) Act, 1960, then the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the

company for the year for which dividend is proposed to be declared or paid or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation in accordance with the provisions of sub-section (2) or against both ;

(c) the Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation :

Provided further that it shall not be necessary for a company to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960.

(2) For the purpose of sub-section (*1*) depreciation shall be provided either—

(*a*) to the extent specified in section 350 ; or

(*b*) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent. of the original cost thereof to the company by the specified period in respect of such asset ; or

(*c*) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five per cent. of the original cost to the company of each such depreciable asset on the expiry of the specified period ; or

(*d*) as regards any other depreciable asset for which no rate of depreciation has been laid down by the Indian Income-Tax Act, 1922 or the rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case :

Provided that where depreciation is provided for in the manner laid down in clause (*b*) or clause (*c*), then, in the event of the depreciable asset being sold, discarded, demolished, or destroyed, the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

(3) No dividend shall be payable except in cash :

Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

(4) Nothing in this section shall be deemed to affect in any manner the operation of section 208.

(5) For the purposes of this section—

(a) "specified period" in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent. of the original cost of that asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the provisions of section 350 ;

(b) any dividend payable in c sh may be paid by cheque or warrant sent through the post directed to the registered address of the shareholder entitled to the payment of the dividend or in the case of joint shareholders, to the registered address of that one of the joint shareholders which is first named on the register of members or to such person and to such address as the shareholder or the joint shareholders may in writing direct.]

[2][**350.** The amount of depreciation to be deducted in pursuance of clause (k) of sub-section (4) of section 349 shall be the amount calculated with reference to the written-down value of assets as shown by the books of the company at the end

of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year, at the rate specified for the assets by the Indian Income-tax Act, 1922, and the rules made thereunder for the time being in force, as normal depreciation including therein extra and multiple shift allowances but not including therein any special, initial or other depreciation or any development rebate, whether allowed by that Act or those rules or otherwise :

Ascertainment of Depreciation

Provided that if any asset is sold, discarded, demolished or destroyed for any reason before depreciation of such asset has been provided for in full, the excess, if any, of the written-down value of such asset over its sale proceeds or, as the case may be, its scrap value shall be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.]

QUESTIONS ON CHAPTER IX

1. Explain what is meant by 'Depreciation'. What broad principles should be followed in the matter of providing for Depreciation so that the *correct* trading results are revealed ?

2. Discuss the different systems of charging Depreciation for the assets of a concern.

3. Discuss the legal position regarding the provision for adequate depreciation on the assets of a Limited Company, distinguishing between Fixed, Floating and Wasting Assets and refer to relevant decided cases.

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[*Hints* : The following Case Laws may be referred to : (i) *Bond v. Barrow Haematite Steel Co., Ltd.* (Floating Assets), (ii) Wilmer *v.* McNamara (Fixed Assets), (iii) Crabtree Thomas *v.* Crabtree (Fixed Assets) and (iv) Lee *v.* Neuchatel Asphalte Co., Ltd. (Wasting Assets). Case decisions may be found conflicting. A Company Auditor will refer to Sections 205 and 350 of the Companies Act 1956, as amended subsequently.]

4. The Directors of a Company, of which you are the Auditor, decline to provide adequate depreciation on the assets.

Discuss your duties from the legal as well as the financial point of view distinguishing between the cases of fixed, floating and wasting assets. (B. Com.)

[*Hints* : The leading case laws in this respect are the "Lee *v.* Neuchatel Asphalte Co., Ltd. series of cases", which are somewhat in contrary to the commercial practice. Unless adequate depreciation is charged the Statement of Affairs will not show a true and fair view. Under the Companies Act, unless the Central Government sanctions dividend payment in the public interest even without providing for Depreciation, a provision for the shrinkage in value must be made. The Auditor must, therefore, bring it to the notice of the shareholders, through his Report on Annual Accounts.]

5. Write a short account of the judgment in the case of Lee *v.* Neuchatel Asphalte Co., Ltd. and criticise same from the point of view of expediency. (B. Com.)

[*Hint* : The decision of the case was that a company could distribute dividends without making good the depreciation of Wasting Assets, if so empowered by its Articles of Association. But from the commercial point of view it may be remarked that depreciation should be charged and a fund be created out of profits so as to replace an asset at the expiry of its estimated life. And modern Law also demand that depreciation would be adequately provided for.]

6. Consider fully the effects of the decision in what are called the "Lee *v.* Neuchatel Asphalte Co., Ltd. series of cases." (B. Com.)

[*Hints* : Held that before dividend is paid, depreciation of Current Assets must be made good but that of Fixed or Wasting Assets may not be made good. Despite the above decisions, the mercantile practice is to the contrary in respect of wasting assets.]

7. What do you understand by "Wasting Assets" ? Give two examples. Should Wasting Assets be depreciated ? (B. Com.)

[*Hints* : Assets of fixed nature which are gradually exhausted while in the process of earning income, such as leases, a mine, etc., are called wasting assets. It is necessary to provide for depreciation so that the asset (or capital) can be replaced when exhausted.]

8. Should depreciation be written off Goodwill ? Consider fully. (B. Com.)

[*Hints* : Goodwill is an intangible asset, and it does not depreciate through use, wear and tear or passage of time. But as the amount of Capital invested in the business ought to be represented by assets that are tangible, Goodwill which was brought into the books of accounts earlier should gradually be written off, especially during years of good business. Based on an uncertain profit-earning capacity this asset should not appear on the face of the Balance Sheet permanently.]

9. A company's block of old motor cars in use is valued at Rs. 5,000 on January 1, 1950 at the written down value according to the usual rates of depreciation. During 1950 some of the cars are sold for Rs. 6,000 and the Directors insist that the profit of Rs. 1,000 should be credited to the Profit and Loss Appropriation Account. As an Auditor what should be your attitude to this procedure ? (B. Com.)

[*Hints* : Subject to the provision in the Articles of Association, capital profit can be available for distribution if only the revaluation of all the assets and liabilities does not reduce the surplus. In this question the actual surplus should be more than Rs. 1,000 as all of the cars have not been disposed of, and the amount of the capital gain is to be worked out by deducting the written down value of only the cars sold from the sale proceeds, Rs. 6,000. The cars that have not been sold should appear on the Balance Sheet at their depreciated value.]

10. State the case of Wilmer *versus* McNamara & Co., Ltd., and comment on the judgement delivered by Stirling J. (B. Com.)

[*Hints* : It was held in this case that a dividend out of the current profits could be declared by a company. without making good depreciation of fixed assets (like Leases, Goodwill or Plant). But from a general point of view it may be remarked here that dividend should not be paid without making good the depreciation of all fixed assets except Investments. The present day law would hardly permit dividend declaration when provision for such depreciation is not done.]

11. Discuss the principle in the case Lee *v.* Neuchatel Asphalte Co., Ltd., and criticise the judgement from the point of view of commercial expediency. (B. Com.)

[Please refer to hints on Q. 10.]

12. A Company working a coal mine has made a profit of Rs. 5,00,000. No provision has been made for Income Tax due on the above profits. Nothing has been written off the value of the wasting asset. A debit balance of Rs. 25,000 in the Balance Sheet of the previous years has been brought over this year but not adjusted. Reserve on Book Debts has been properly provided for and depreciation on Fixed Assets properly made. Commissions on Shares and Preliminary Expenses have been written off on a five-year basis.

The Directors want to distribute the entire amount of the profit of Rs. 5,00,000 by way of Dividends to Shareholders. Your view as an Auditor is invited. (B. Com.)

[*Hints* : Adequate provision must be made for liability for Income Tax before any dividend is declared. Regarding the debit balance of Rs. 25,000 the case law of the Ammonia Soda Co., Ltd. *v.* Chamberlain and others may be referred to. But it is advisable to adjust such debit balance with the current year's income to arrive at the distributable profits.

Reserve on Book Debts, depreciation on fixed assets, and the writing off of commission on shares and of preliminary expenses should have been treated properly.]

13. Having suggested the necessity of a provision for depreciation of Machinery in the accounts of each of three companies, the respective Boards of Directors raise objection on the following grounds respectively :—

(a) The cost of similar machinery having risen, nothing should be written off, as it is actually more valuable.

(b) Repairs done have fully maintained the Machinery, which is as good as new.

(c) To charge depreciation to the same extent as in a good year would prevent the declaration of a dividend. with the result of dissatisfaction amongst the shareholders and a possible fall in the price of shares. Criticize these arguments. (M. Com.)

[*Hints* : The following observations should be made against the arguments of the Directors :—

(a) Depreciation must be provided for in the Accounts as per Income Tax Schedule in spite of the fact that the value of Machinery has increased ; otherwise the Auditors will qualify their Report to the Shareholders.

(b) Even if the Machinery is as good as new due to repairs Depreciation must be written off ; otherwise the Auditors will give a qualified Report.

(c) That dividend cannot be declared if Depreciation is charged is no reason for non-provision of Depreciation in the Accounts. Adequate Depreciation must be provided for in the Accounts every year.]

14. In Auditing the accounts of a Limited Company you ascertain that no provision has been made for depreciation on Wagons purchased under hire-purchase system. The Directors contend that as the wagons do not belong to the company, there is no need to make provisions for depreciation and indeed such a course would be quite erroneous.

Draft a suitable reply stating the reasons. (M. Com.)

[*Hints* : Adequate Depreciation must be provided in the Accounts on Wagons purchased under Hire-Purchase Agreement. As these Wagons will become the property of the Company after the termination of all Hire-Purchase payments, unless depreciation is provided every year, the valuation of the Asset will show much in excess of the realisable value when the Asset becomes the property of the Company under the strict legal sense

In case the Asset is seized by the Seller for non-payment of instalments, the capital loss incurred will be less if depreciation has been provided annually.]

15. The Directors of a Limited Company are of the opinion that depreciation on Fixed Assets should be provided at the rates allowed by Income Tax. Do you agree ? (M. Com.)

[*Hints* : Depreciation on Fixed Assets is usually provided at Income Tax Rates following the provisions of sec. 350 of the Companies Act. In the cases of Building, Loose Tools, Furniture, etc., this method is justified but in the case of Machinery and Motor cars and vans the Rates of Depreciation seem to be excessive with the result that these Assets show nil value when they are in active service.]

16. Do you consider that a company is justified in providing depreciation on the basis of replacement cost ? Give your answer stating reasons. (M. Com.)

[*Hints* : Depreciation should be provided in terms of the Income Tax Schedule as far as practicable and not on the basis of replacement value. Where, for example, the book

value of Machinery is Rs. 10,000 and replacement value Rs. 20,000, if Depreciation is provided on the basis of the replacement value, the Profit will be unnecessarily decreased.]

17. Fixed Assets need to be written down in the Books of the undertaking which owns them for a variety of reasons. Enumerate and contrast the principal reasons and give a list of three types of Fixed Assets stating in each case which reason or reasons apply. (M. Com.)

[*Hints* : Fixed Assets should be written down every year for the following principal reasons :—

(a) When the Assets are out of use they should show nil value, or a scrap value ;

(b) When the Assets show nil value new Assets are to be acquired with the amounts charged to the Profit and Loss Account by way of Depreciation ;

(c) The Balance Sheet Valuation shows the correct state of affairs if depreciation is provided annually.

Three types of Fixed Assets are the following :—

(i) *Buildings* - This kind of Asset should be written down considering the life time by Fixed Instalments annually.

(ii) *Machinery*— This should be depreciated by Normal Depreciation in terms of Income Tax Schedule.

(iii) *Furniture*—This should be Depreciated by Reducing Instalments every year.]

18. In presenting the draft Balance Sheet and Profit and Loss Account of a Company of which you are the Auditor, you are informed that no provision has been made in the Accounts for Depreciation of Plant and Machinery since the Directors consider that—

(a) the amount of Depreciation already written off has been excessive ;

(b) the market value of such assets is much in excess of their present book value ;

(c) the current year's profits are insufficient to cover provision for further depreciation.

Draft a letter to the Directors of the Company giving your advice on the matter. (*Chartered Accountants*)

[*Hints* : (a) The Auditor should examine the Assessment Order and the Income Tax file in which the copy of the Return filed with the Income Tax Officer will be seen along with the Depreciation Statement in Yellow Paper. From this Statement the Auditor should see the written down values of the Assets and compare them with those as shown in the Balance Sheet under 'Plant and Machinery.' If the book value is much lower than the written down value for tax purposes the Auditor may not insist on Depreciation being provided but at the same time he should mention in his Report that no depreciation has been provided in the Accounts ;

(b) Even if the Market Price is much higher depreciation should be provided ;

(c) Depreciation must be provided even when profit of the Current year is inadequate.]

19 (a) Discuss the question whether 'Goodwill' should be written down from time to time.

(b) Some authorities aver that every established and solvent business has an inherent goodwill. Would you, as Auditor of a firm that does not show Goodwill among its assets, recommend the inclusion of the value of goodwill in the Balance Sheet, and if so, why ?

(Chartered Accountants)

[*Hints* : (a) Goodwill should be written off from time to time. This Asset appears on the Balance Sheet when a running business is acquired from the Vendor by a Company or when a partner joins or leaves a firm The item 'Goodwill' has no immediately realisable value to a concern and, therefore, Goodwill should be written off gradually.

(b) If there is inherent goodwill of a business there is no need to raise 'Goodwill' in the Balance Sheet. Unless a business is running at a considerable Profit if goodwill appears in the Balance Sheet that will not attract the public. The easiest way of determining goodwill is three years' purchase price of the Average Profit and unless there is profit even if the Goodwill Account is raised it has no meaning.

Please also refer to hints on Q. 8.]

20. Discuss :—

(a) the main advantages and disadvantages of the principal methods of providing for depreciation of the Plant and Machinery of a manufacturing concern ; and

(b) the matters to be considered in determining whether the depreciation provided is adequate.

(*Chartered Accountants*)

[*Hints* : (a) There are two methods for the provision of Depreciation for Plant and Machinery, viz., (i) Fixed Instalment Method and (ii) Reducing Instalment Method. Under method (i) such a fixed proportion of the original cost of the asset is debited to the Profit and Loss Account as will result in a provision being made for the total cost less scrap value of the asset at the end of the expected life. The main advantage of this method is that the Profit and Loss Account is charged with an equal amount every year during the life-time of the asset. The disadvantages are that a detailed Plant and Machinery Register is to be maintained for different dates of purchase in order to calculate percentage on original cost. Besides, the Profit and Loss Account in later years is charged heavily on account of extensive repairs when depreciation is constant and this causes an unwelcomed decrease in profits. Under method (ii) the prominent advantage is that the Profit and Loss Account is not affected as in method (i), because the depreciation figure diminishes gradually and thus the repairing charges, that will be heavy and heavier in subseq nt years, are balanced. The main disadvantage of this system is that in later years the depreciation charged against the profits is low and when the asset becomes obsolete, there may remain a book value on the Balance Sheet.

(b) The Income Tax File in which Demand Notes, Assessment Orders and Depreciation Statements showing the written down value of Assets for Income Tax purposes are recorded will give an indication whether adequate provision for depreciation has been made in the Accounts. If the Book Value of Assets as shown on the face of the Balance Sheet is lower than the written down value as per Depreciation Statement submitted to the Income Tax Authorities, the Depreciation provided in the Accounts will be considered adequate. Further, the Replacement Value of the Assets as per Market Price should also be taken into consideration.]

CHAPTER X

RESERVES AND SINKING FUNDS

When a person does not spend the whole of his earnings, it is said that he has a Reserve. Likewise, when a business concern does not give to the owners the entire Profits, a *Reserve* is built up. Reserve is the *unspent income* of a person or an institution. For a trading organisation it is the *undistributed Profits.*

Meaning of the term 'Reserve'

Reserves may be created in various manners. When Reserve is built up out of profits earned in the usual course of the business of a concern or from the normal incomes of an individual or an institution, it should be called Revenue Reserve. As opposed to that, Capital Reserve is created through gains of Capital nature. When, for instance, there is profit from the sale of a Fixed Asset, *or* when Premium money has been collected on Shares or Debentures issued by a Joint Stock Company at a premium *or* the Shares of a Company have been forfeited, such profits earned outside the concern's normal trading line will go to build up what is called Capital Reserve. Capital Reserve is to be utilised only in writing off Capital Losses, that is losses other than those sustained in course of normal trading operations. A distinction between General Reserve and Specific Reserve is of great importance. *General Reserve* is that portion of Revenue Reserve which is meant for strengthening the financial position of the concern in general or for being available for a sudden contingency. *Specific Reserve*, on the other hand, will be a Reserve created for a specific purpose and to be utilised only for that purpose. Reserve for Bad Debts, for example, is a *Specific Reserve* ; for, the undrawn surplus standing at the credit of this Reserve Account is available only for setting off losses on account of Bad or unrealisable Debts. Other examples of Specific Reserve are Reserve for Repairs and Renewals, Reserve for Dividend

Different kinds of *Reserves* and *Reserve Funds*

Equalisation, Investment Fluctuation Reserve, etc. Whether the term 'Reserve Fund' has any special meaning should be examined. When the money set apart from the divisible profits as a Reserve is invested outside the business and the investment is earmarked for the particular Reserve, the term *Reserve Fund* is referred to. It is the surplus by which the Assets of a concern exceed the Paid up Capital and Liabilities. The investment should be such that it can easily be converted to liquid cash, whenever funds would be required. Where the liability item appearing on a Balance Sheet is simply 'Reserve', it does not imply any outside investment, and, evidently, the money is employed within the four walls of a concern's internal activities. The difficulty is that when a purpose has to be met, sudden withdrawal of Funds from within the business may affect its smooth-sailing. The term 'Sinking Fund' has now to be explained. A Sinking Fund may be created for two purposes : (i) Redemption of a Liability like Repayment of money to the Debentureholders or to the Redeemable Preference Shareholders ; (ii) Replacement of an Asset. Money taken out of divisible profits is invested in a such a manner that at the needed moment the requisite amount is easily available. Where the *Sinking Fund* is for redemption of a liability, the annual amount to be deducted from the profits should not be set aside as a charge against, but should go by way of appropriation of, the trading profits. When the *Sinking Fund* is for the replacement of an Asset, the annual amount will be a charge against the trading profits and not an allocation of profits, and this must be debited to Profit and Loss Account, before Net Profit is arrived at. The purpose behind a Sinking Fund should be explicitly stated on the Balance Sheet. A distinction between *Reserve Fund* and *Sinking Fund* may thus be drawn. While a Reserve Fund is maintained as a measure of prudence to guard against future unforeseen contingencies, a Sinking Fund is created to meet a specific and known Liability at a definite future date. Sometimes, the presence of a Reserve is not disclosed on the Balance Sheet This is a case of Secret Reserve or Internal Reserve. Such Reserve is created in various ways, viz., by making over-provision for Bad and Doubtful Debts or by undervaluing stock-in-trade or any other Asset or by overvaluing a Liability

or through treatment of Capital expenditure as Revenue expenditure. Now-a-days, creation of Secret Reserve is not usually encouraged by the Registrar of Companies or the Income Tax Authorities.

Auditor's Duty regarding creation of Reserves

So far as Specific Reserves are concerned, the Auditor should see to the adequacy of the amount for which a particular Reserve is created. He should be satisfied as to the adequacy of a Specific Reserve, by taking into consideration all the facts and matters relating to the purpose for which the Reserve is created. For instance, while checking the item 'Provision for Bad & Doubtful Debts, from the Bill Register should be seen the dates of the Bills, sent to the parties for realisation of outstanding debts. A list of the old outstandings should be prepared by the Auditor and the nature of attempts made by the Company for collecting the moneys should be inquired into. The Auditor should raise his objection in cases of both underprovision and overprovision. And, where necessary, he will qualify his Report. As to the creation of *General Reserve*, the Auditor has nothing to say against the discretion of the Management. To make a Reserve for strengthening the financial condition of the business is a question of prudence and if a lack of prudence is noticed, the Auditor has no ground for raising his voice of protest. Where, however, the Articles of Association of a Company provides for the creation of a *Specific Reserve*, the Auditor is to see that the prescription of the Articles has been complied with. The Auditor would usually be failing in his duty, if he signs a Balance Sheet without qualifying his Report where the Provision for Bad and Doubtful Debts is inadequate. In the case of **Arthur E. Green & Co. v. The Central Advance and Discount Corporation, Ltd. (1920)**, it was held by the Court that the Auditor was guilty of negligence of duties for accepting a Certificate from the Manager about 'Provision for Bad Debts'. The Accounts showed a portion of Book Debts as 'good', *though the Debts were time-barred and absolutely Bad.* In another case, **Dovey & others v. Cory (1901)**, the decision, however, was otherwise. In this case large sums were advanced by a bank to the Directors and uncreditworthy customers, and dividends

were paid after crediting 'interest' on these advances. Some of these advances turned 'bad' and no interest was realised. In the Accounts there was inadequate Provision for Bad Debts. Action was brought against the Directors of the bank, alleging irregular dividend payment. It was held that, in the absence of suspicious circumstances, the Directors were entitled to rely on the officers of the Company in the matter of compilation of Accounts. If during the course of his Audit, the Auditor finds that *Secret Reserves* in the form of undervaluation of Assets or overestimation of liabilities exist, he should take the matter up with the Management and discuss at length the *reason* or *policy* behind the making of such hidden reserve. Unless there is an absolute case for the presence of *Secret Reserve*, the Auditor should ordinarily disapprove of it and should ask for an amended Balance Sheet. If the Management is unwilling to accept the views of the Auditor, he has to qualify his Report calling attention to the undesirable existence of Secret Reserve, the wrong valuation of particular Assets or Liabilities being pointed out. Two important case decisions coming from British Courts may be cited here in this connection. **In Newton *v.* Birmingham Small Arms Co., Ltd. (1906)** the Articles of Association of the Company were altered by Special Resolution to give the Directors powers to build up Secret Reserve without showing it on the face of the Balance Sheet. The Special Resolution also gave power to the Auditors to verify the transactions relating to the Secret Reserve creation and to see that this Reserve was properly utilised. The Special Resolution provided that the Secret Reserve matter would not be brought to the notice of the shareholders by the Auditors through their Report Challenging the validity of the above provision of the Articles of Association when the case under study was instituted, the learned judge held that the restriction placed upon the Auditors by the Articles concerning their Report to the shareholders was *ultra vires*, that is, against the accepted canons of law. It should be observed that where *Secret Reserve* exists, the Auditor's certificate that the Profit & Loss Account and the Balance Sheet exhibit the true and correct position of the company is of little value. For the true state of affairs cannot be reflected by the Balance Sheet when the assets and liabilities

have not been properly valued. **In the Royal Mail Steam Packet, Ltd.** Case (*Rex v. Kylsant and Morland,* 1931) criminal proceedings were instituted against the Chairman of the company for false Annual Reports (of 1926 and of 1927) to the shareholders and against the Auditor for aiding and abetting the offence. For several years this company had been running at a loss but their Accounts showed considerable profits available for being distributed as dividends. This manipulation of the Accounts was possible through the utilisation of special credits in connection with Excess Profits Duty recoveries and Taxation Reserves created in excess out of profits prior to 1926. On the face of the Final Accounts there was no indication of any Secret Reserve being utilised for dividend payment, and the shareholders were quite in the dark about the true trading position. The Company, in spite of huge trading losses in 1926 and 1927, declared dividends by utilising the *Secret Reserves.* It was held by the Court that neither the Chairman nor the Auditor was guilty under the *Larceny Act 1861* for issuing false Reports to the Shareholders but the Chairman only was found guilty for publishing a *Prospectus containing false information.* Though in this special case the Auditors were freed from the charge brought against them, they should not as a rule be liberal in the matter of allowing undisclosed Reserves to be utilised for inflating the profits with the resultant dividend payment. After the Companies Act, 1956, as amended subsequently, the attitude of law towards the presence of any Hidden Reserve has been more strict. The Auditor should without any hesitation mention in his Report the presence of Secret Reserve.

QUESTIONS ON CHAPTER X

1. What is meant by the term 'Reserve'? Explain the necessity of creating a Reserve.

[*Hints* : In years of success when there is good profit, a portion of the profit should be set aside. This would strengthen the financial position of a concern. To meet contingencies of specific nature the creation of a Reserve is of utmost importance. For, otherwise, when a particular contingency, such as Bad Debt &c. will arise, the particular year's profits will be unduly affected.]

2. Distinguish between a General Reserve and a Special or Specific Reserve and explain the difference of their treatment in the Profit and Loss Account. (B. Com.)

[*Hints* : General Reserve is to strengthen financial condition in general and is a provision for unknown contingencies, while Special or Specific Reserves are for known contingencies. Special Reserves are provisions for debenture redemption, dividend equalisation, etc., and Specific Reserves are provisions against bad debts, depreciation, etc. Treatment for Specific Reserves in the Profit and Loss Account will be by way of a charge against the profits while, for both of the Special and General Reserves, there will be an appropriation of the profits.]

3. Give an illustration of a reserve of each class and state how they should appear in the accounts of a limited Company, and describe an Auditor's duty in relation thereto. (B. Com.)

[*Hints* : Reserves may be *Revenue, Capital* or *Secret* in nature. Revenue Reserves, again, may be (i) *Specific,* e.g., provision for bad debts, (ii) *Special,* e.g., provision for dividend equalisation, or (iii) *General,* to meet unknown contingencies. Specific Reserve appears in the Balance Sheet under the head 'Current Liabilities and Provisions', while Special and General Reserves appear under 'Reserves and Surplus'. (*Provision for bad debts,* instead of being shown in the Liabilities side, is shown in the Assets side as the amount deducted from 'Sundry Debtors'.) Capital Reserve arises from Capital Profits, e.g., forfeiture of Shares, issue of Shares or Debentures at a premium, etc., and appear in the Balance Sheet until such profits are utilised for writing off extraordinary losses. An Auditor should see that adequate Specific (or Special) Reserve is maintained and he will leave the raising of General Reserves to the discretion of the Management. A Company Auditor will examine the provisions of the Articles regarding creation of Reserve. While Special and General Reserves are to be disclosed in the Balance Sheet, Secret Reserves should be allowed within reasonable limit only if it is maintained out of a genuine motive to serve the best interests of the shareholders.]

4. (a) What do you understand by the term 'Maintenance Reserve Account' ?

(b) In what type of business can a Maintenance Reserve Account be suitably operated ?

(c) How is this Reserve shown in the Annual Balance Sheet ? (B. Com.)

[*Hints* : It is a reserve for repairs and renewals charges of those fixed assets for the maintenance of which such charges are considerable, varying from year to year. It can suitably be operated in any business where repairs and renewals charges are high and specially in those concerns where delicate machines are in work. It is a charge against the profits and appears on the Balance Sheet under a distinct head.]

5. What is a Secret Reserve and how may it be created ? What are the points in favour of and also against such creation ? What would be your duty, as an Auditor to a Bank, in regard to commenting on a large Secret Reserve in your Report to the Shareholders ? (B. Com.)

[*Hints* : It is an internal reserve which necessarily remains *undisclosed* in the Balance Sheet. Undervaluation of assets, overvaluation of liabilities, depreciation in excess and charging a Capital Expenditure as a Revenue one are some of the methods to create such a reserve. Secret Reserve is *essential for public confidence in a Bank*. An Auditor may allow Secret Reserve only after satisfying himself that no malpractice is in operation and that it is maintained in the interest of the shareholders.]

6. What are Secret Reserves ? What Safeguards should Auditors observe with regard to the creation, existence or utilisation of such reserves ?

(National Diploma in Commerce)

7. State how an Auditor might observe a "Secret Reserve" in the affairs of a concern, although there might be no indication of such a reserve in the Balance Sheet.

(Chartered Accountants)

[*Hints* : Where Secret Reserve exists, the Balance Sheet would not give any indication of such existence. An Auditor may detect that assets have been undervalued, through charging of excessive depreciation, or, liabilities have been overestimated to create such a reserve. The treating of Capital Expenditure as Revenue and deliberate over-looking of prepaid expenses, incomes accrued but not received, appreciation of assets, etc., are other symptoms of such reserve and these should be carefully scrutinised for detecting the existence of a hidden Reserve.]

8. A company seeks to capitalise items which are, in your view, revenue charges. It is, however, urged upon you that (i) the depreciation of assets in previous years has been excessive and thus Secret Reserve has been created which can well bear these charges, and (ii) to insist upon debiting them against revenue will result in a loss which may seriously prejudice the company.

As an Auditor what should be your attitude and why ?

(B. Com.)

[*Hints* : Under no circumstances, should a Revenue item be treated as a Capital one. The shareholders should be notified about the excess of Secret Reserve and the Directors should be instructed to write up the assets to the extent of over-depreciation. Excess arising as a result should be credited to Profit and Loss Account and thus the Company's trade prospect may be saved from being prejudiced. The decision of the Court in Stapley *v.* Read Bros., Ltd. (1924—10 T.L R. 412) ought to be studied in connection with the writing off of a debit balance on Profit & Loss Account from the restoration of an Asset to its fair value.]

9. In the course of an Audit of a Company you find :

(a) That the business premises has for many years been depreciated at such an abnormally high rate that in the year under Audit the value of the premises has been reduced to nil, although a very good substantial building is physically in existence.

(b) That the Closing Stoc has been considerably undervalued.

Draft a letter to the Board of Directors on the basi of your above findings. (B. Com.)

[*Hints* : Directors should be informed that both the facts give rise to Secret Reserve. As such, to bring the business premises to nil would keep the shareholders in the dark about the situation. It should be pointed out that such drastic undervaluation of Assets might stand in the way of securing any loan from Bank or others, and claiming any depreciation, so far as income tax is concerned. By drawing the attention of Directors to the risk of withholding the actual position of closing stock, their estimated requirements of Secret Reserve and their proposals to deal with such Reserve should be demanded.]

10. What is the position of the Auditor of a Company regardnig the adequacy of Reserve for Bad and Doubtful Debts? Refer to two important legal decisions in support of your answer.

(*M. Com.*)

[*Hints* : On the realisability of the Book Debts, as are exhibited in the Balance Sheet, the financial stability of a concern much rests. If the Auditor certifies a Balance Sheet in which the Provision for Bad & Doubtful Debts is inadequate he will be guilty of negligence of duties. In the case of *Arthur E. Green & Co v. The Central Advance & Discount Corporation, Ltd.* it was held by the Court that the Auditor was guilty of negligence of duties for accepting a certificate from the Manager about Provision of Bad Debts. The accounts showed a number of Book Debts as good which were time-barred and absolutely bad.

In the case of *Dovey v. Cory* large sums were advanced to the Directors and unreliable customers and Dividends were paid after crediting interest on these advances. Some of these advances were bad and no interest was realised. In the Accounts there was no sufficient provision for Bad Debts. Action was taken against the Directors of the Bank and it was held that in the absence of suspicious circumstances the Directors were entitled to rely on the officers of the Company for the compilation of the Final Accounts.]

11. Describe and contrast .—

(i) A reserve which is a charge against Profit ;

and (ii) A Reserve which is an appropriation of Profit.

Give an illustration of a Reserve of each class and state how they should appear in the Accounts of a Limited Company.

(M. Com.)

[*Hints* : (a) When a Reserve is created by debiting the Profit and Loss Account before Net Profit is arrived at, such a Reserve will be a charge against the Profits and has to be provided for even when there is loss. When, on the other hand, a Reserve is made for known and unknown contingencies or for ploughing back the Profits, such Reserve will be by way of appropriation of the already ascertained Net Profit.

(b) **Provision for Bad and Doubtful Debts, Provision for Discount on Debtors, etc., are charges against the Profits of a concern. These provisions should be shown as amounts deducted from 'Sundry Debtors' on the face of the Balance Sheet. In a Company Balance Sheet they would appear under the heading *Current Assets, Loans and Advances.* In this connection mention may also be made of such Reserves as Maintenance Reserve, Rehabilitation Reserve, &c.**

(c) Provision for Taxation, Development Reserve. General Reserve, Dividend Equalisation Reserve, etc., will go as appropriation of the profits of a concern. Provision for Taxation and Provisions for other contingencies will appear in a Company Balance Sheet under the heading ***Current Liabilities and Provisions***; other Reserves will come under ***Reserves and Surplus.***]

12. What is Secret Reserve? State how it is usually created and give a few reasons in support of and against such a Reserve. Is it possible under the Companies Act, 1956, to create such a Reserve? What information should be disclosed in the accounts, if dividends are paid out of such a Reserve? (M. Com.)

[*Hints* : Secret Reserve is the Reserve not exhibited on the face of the Balance Sheet. Usually it is created through undervaluation of assets, overestimation of liabilities, overcharging of depreciation, building up of Specific Reserves like Reserve for Discount on Debtors &c. exceeding what would be adequate. *or* treatment of Capital Expenditure as Revenue Expenditure, with the result that the business condition seems weaker than it actually is. Competition is thus shut out and labour given less opportunity to cry for a higher wage. The Reserve that is secretly built up may be drawn upon in critical years and in this way a crash in share price may be prevented and public confidence commanded. Institutions for whom the confidence of the people is the mainstay may, therefore, profit from the creation of Secret Reserve. But the critics would complain of the untrue and misleading picture conveyed by the Accounts. Taking brief for the shareholders they would emphatically protest against profits being withheld. Shares may have a fall in value because of the paler look worn by the Company. The knowledge of the accumulated Reserves created secretly may induce

the Management to go lethargic. The Directors may not pay due regard to the bonafide purpose behind the creation of a Secret Reserve and thus they may go against the interests of the shareholders. The Auditor must read the intentions of the Management with an eye of critic. He must guard himself against the charge of giving a false certificate on the Balance Sheet. Under the present Companies Act no Secret Reserve is permitted to be created and no Dividends are allowed to be paid out of such Reserves. The Statutory Auditor will qualify his Report if Dividends are paid out of Secret Reserves and state on the face of the Balance Sheet the existence of the Secret Reserve and the fact that Dividends were paid out of such Reserve.]

CHAPTER XI

PAYMENT OF DIVIDENDS

The question of dividend payment or dividend declaration will arise only when the Profit and Loss Account of a Company has a credit balance after *adequate depreciation* according to sections 205 and 350* of the Companies Act has been charged and all liabilities including taxation duly provided for. The *appropriation* of the profits as revealed by the Profit & Loss Account is a very intricate matter for a Joint Stock Company.

Appropriation of Profits

What part of the Profits should go to the shareholders as dividend is a quèstion highly controversial. It is difficult to lay down in clear cut terms what exactly shall be available for distribution as dividend. If decisions of leading cases over the matter are referred to, they will be found conflicting. Nevertheless, certain broad principles regarding dividend payment are outlined in the following paragraph. Dividend, as a rule, should be paid only out of clean profits, as otherwise it would be a case of Dividend being paid from out of Capital.

Dividends usually should be paid out of the Profits. Dividend payment may also be arranged out of moneys provided by the Central Government or a State Government for the payment of Dividend in pursuance of a guarantee given by that Government. Before the profits are made available for dividends, all the assets should be subjected to a proper revaluation. If shrinkage in value is noticed, the difference must be written off prior to dividend declaration.

Broad Principles regarding payment of Dividend

If, however, there is an appreciation in the value of an Asset, that appreciation should not be taken into consideration, as unrealised profits are not to be given away as dividend. The basis of valuation should be as follows: for the Fixed Assets, the Original Cost *less* accumulated depreciation and for Floating

* The contents of Sections 250 and 350 of the Companies Act have been quoted verbatim in the latter part of Chapter IX.

Assets, the Original Cost or Realizable Value (present Market Price), whichever is lower. It has to be borne in mind that the provisions of the Articles of Association are to be taken into proper regard.

Important case decisions over payment of *Dividends*

As cases centring round the Payment of Dividends brought before the lawcourts have their important bearing on the discussion of the topic, some of them are cited here. In **Foster *v.* The New Trinidad Lake Asphalte Company, Ltd. (1901)** with other Assets a Book Debt of huge amount was taken over by the Company at its formation. In the Books of the Company no value was placed on this Asset, because the entire portion of the Debts was considered bad and irrecoverable. Subsequently the full amount together with interest was realised and the *Directors proposed* to distribute this amount as Dividend without taking into consideration the decrease in the value of other Assets. It was held by the Court that the realised amount of the Book Debts considered *bad* could not be a profit available for Dividend unless a surplus remained after a revalution of the whole of the Company's Assets. In **Lubbock *v.* The British Bank of South America (1892)** the case was like this. The Banking Company had their branch business in Brazil. They sold their business including Goodwill to another Company for a huge amount under the condition that business would be discontinued in Brazil. The sale brought for the vendors a handsome profit and this was Capital Profit. The Directors, in keeping with the terms of the Articles of Association, transferred a part of this profit to Reserve Fund and distributed the balance as Dividends. The Court's award was in favour of the Directors. It was held that a profit on the sale of a part of the entire undertaking of a Company could be made available for Dividend if there was such a provision in the Articles of Association. If an identical case was instituted today, the decision of the Court, in the light *of the provisions of the present Companies Act, would have* been for taking Capital Profits to Capital Reserve, not to be made available for dividend payment. For the benefit of the hareholders, however, Capital profits may be utilised for the ssue of Bonus Shares with sanction of the Central Government,

and with approval of the Board Meeting and the Shareholders' Meeting. **In Bolton *v.* Natal Land and Colonisation Company, Ltd. (1892)** the Profit and Loss Account for the year 1882 was debited with £70,000 in respect of Bad Debts and at the same time was credited with almost similar amount owing to the Appreciation in the value of Land. In the year 1883 there was a profit which the Directors proposed to distribute as Dividend. The case was brought for restraining the Directors from this Dividend payment on the ground that the value of Land shown on the Balance Sheet was in excess of the true value. The plaintiff wanted that the difference in the value of the Asset be adjusted before Dividend declaration. The Court was of the opinion that Dividends might be paid out of Current Profits without adjusting the value of Land. Law today would, however, ask for a revaluation of all the Assets in a case like this. In **Ammonia Soda Co., Ltd. *v.* Chamberlain (1918),** in a certain year the debit balance of the Profit and Loss Account of the Company was written off by taking to the credit the Appreciation in the value of the Company's property as a result of discovery of a new bed of rocksalt. In subsequent years the net profit made by the Company was distributed as Dividends, nothing having been done to adjust the Profit & Loss Account debit balance referred to above. According to the Court, the Directors of a company could pay Dividends out of current Profits without writing off a debit balance of the Profit and Loss Account of the Company arising through losses in earlier years. Three case decisions have been discussed under the Chapter 'Depreciation' already. These are **Lee *v.* Neuchatel Asphalte Co., Ltd., Verner *v.* The General Commercial and Investment Trust, Ltd., and Wilmer *v.* McNamara & Co., Ltd.,** and they have a cosiderable bearing on the Dividend payment question. It should be noted that the Courts decide a particular case entirely in the light of, and in the full context of, the circumstances of the case. It should further be noted that the attitude of the modern lawcourts, in *the light of the recent changes in Company Regulations would* be more strict than before in respect of the declaration and payment of Dividends. The judges seem to be of common attitude in one respect. It is this that the shareholders' Capital cannot be used to pay a Dividend. The present day law insists

so much on adequate Depreciation being provided for, as, otherwise, the Profits will get inflated and a case of Dividend being paid out of capital will arise.

Before being satisfied that the payment of Dividends in a particular case has been regular, the Auditor should carefully consult (i) the relevant provisions in the Companies Act* and in the Articles of Association, (ii) the Directors' Resolution recommending the Dividend payment, and (iii) the Shareholders' Resolution passing it.

Matters to engage the special attention of the Auditor in respect of Dividend payment

The Auditor's special notice should be drawn to the rate of Dividend and provisions made for Income tax and Super tax, wherever applicable. Dividends will be declared by the Company in General Meeting, but no dividend shall exceed the amount recommended by the Board of Directors who are in the know of the Company's inner working. Before recommending any Dividend, the Board may set aside out of the profits of the Company such sums as it thinks proper as a Reserve or Reserves, for contingencies, or for equalising Dividends. The Board may also carry forward any Profits which it may think prudent not to divide, without setting them aside as a Reserve. Dividend would be declared only on the Paid up portion of Shares held by the Members, and the Board may deduct from any Dividend payable to any Member all arrears of Share call moneys. Dividends would be paid either in Cash or by issue of Bonus Shares. A separate Bank Account must be maintained with a Scheduled Bank for Dividend payment operations. The Dividend which is payable in cash may be paid by Cheque or by Warrant sent through the post to the registered address of the shareholder entitled to the payment of the Dividend. The Auditor should look to it that Dividend is paid only to the registered shareholders, or to their order, or to their bankers. Where a Share Warrant has been issued in accordance with the provisions of section 114, Dividend would be paid to the bearer of such Warrant or to his bankers. Within forty-two days from the date of the declaration of a

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* Sections 205, 206 and 207 deal with the question of regularity or otherwise in the matter of Dividend payment and of proper charging of Depreciation prior to Dividend declaration.

Dividend, its payment must be arranged, or the Warrant in respect thereof must be posted. Else, those that are at the helm of affairs in company administration may be liable to imprisonment and fine. The punishment shall not be hurled if the Dividend payment could not be done because of the reasons stated in the second paragraph of section 207. The Articles of Association may provide for *Interim Dividend* being paid pending ascertainment of Annual Profits. The Auditor should allow Interim Dividend payment only if such payment is safe on the basis of satisfactory business already done during the interim period and the expectation of good trading results during the remaining period of the Accounting year. The justifiability of Interim Dividend declaration also rests on there being adequate liquid resources at the disposal of the Company. Once a Final Dividend is declared, an interest-free debt devolves on the shoulder of the Company, and this debt is to be shown on the Liabilities side of the Balance Sheet so long as it is not redeemed by payment, in cash or in kind*. The Company does not, however, run into any such debt as a result of an Interim Dividend declaration, which the Company may rescind. Sometimes the Auditor's advice is sought as to *provision of money* when Cash balance is inadequate. If the Profit money is locked up in the Stock in-trade or in the Book Debts, the Auditor may advise the client for arranging overdrafts from Bank on the hypothecation of Stock or Book Debts. If, on the other hand, the Profit money is blocked in other Assets or if it is utilised for business expansion purpose, Bonus Shares may be issued, or, in the alternative, Dividend may be paid out of the proceeds of fresh issue of Shares or Debentures.

QUESTIONS ON CHAPTER XI

1. What is meant by 'Divisible Profits' of a Company? State the broad principles regarding Dividend payment.

[For an exhaustive answer, please refer to text.]

2. Can Capital Profits be distributed as Dividend? If so, under what circumstances would such a distribution be made? (B. Com.)

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* Finance Corporations often meet their Dividend liability to Shareholders by transferring to them the Shares or Debentures of other Companies. This is known as Scrip-Dividend.

[*Hints*: The question of *Capital Profits* being available for Dividend distribution is a highly controversial one. Different Case Laws established different views. In *Lubbock* v. *The British Bank of South America*, it was held that Capital Profits were available for distribution as Dividend if the Articles so allowed and if such profits were actually realised. In *Foster* v. *The New Trinidad Lake Asphalte Co., Ltd.*, however, the decision was that no such payment could be made unless all the assets were revalued and profit still did remain.

Capital Profits arise from *sources* like (i) issue of Shares and Debentures at a premium, (ii) forfeiture of Shares, (iii) sale of an Asset at a price higher than the book value, etc., and a gain of this kind, non-trading in character, should be applied, being first transferred to Capital Reserve, only for the *meeting of Capital Losses**, i.e., losses other than those sustained in the course of a Company's normal trading operations. Capital Profits may also be utilised in writing off, partly or wholly, the debit balances of Accounts like Preliminary Expenses, Underwriting Commission, Goodwill, &c., if any. In the absence of any such balance, and where the Directors do not deem it necessary to transfer a portion of the realised Capital Profits to Capital Reserve, that particular portion may be given away as Dividend, subject to the *sanction of the Articles*, and after a revaluation of all the Assets.]

3. What do you understand by 'Divisible Profits'? Support your answer by reference to at least two important case laws. (B. Com.)

[*Hints*: 'Divisible Profits' is a very intricate term. It is not easy to define it. Certain fundamental principles should be followed to determine the extent of 'Divisible Profits':—

(a) Section 205 of the Companies Act forbids payment of dividend except out of profits, or except out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government. No payment can be made before charging adequate Depreciation on the Assets as prescribed under sections 205 and 350.

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* Capital Losses occur from (*i*) issue of Shares at a Discount, (*ii*) issue at a Discount, or redemption at a Premium, of Debentures, (*iii*) sale of an Asset at less than book value, etc.

(b) Amount of 'Divisible profits' should be determined after providing for Income tax, Super tax, etc.

(c) Government may prescribe maximum rates of dividend payable by a Company or such conditions may be imposed on a borrowing Company by a Finance Corporation. In such cases the dividend declared must not exceed this limit.

(d) Dividend must be declared by shareholders in a General Meeting, but it can, in no case, exceed the rate fixed by Directors. Subject to the above, the detailed procedure for the determination of 'Divisible Profits' may be laid down in the Articles of a Company. Besides current expenses, all shrinkage in the value of assets should be set off against current income before the same is made available for dividend payment.

Case Laws : In this context attention may be invited to (i) Foster *v.* The New Trinidad Lake Asphalte Co, Ltd. and (ii) Lubbock *v.* The British Bank of South America, for a general guidance.]

4. The Directors of a Public Limited Company desire to distribute dividend out of profits realised as stated below :—

(a) Profits derived from the forfeiture and re-issue of Shares.

(b) Profits derived from redemption of company's Debentures at discount in the open market.

(c) Profits realised on sale of company's fixed assets.

(d) Bounties received by the company from the Central Government

How will you, as Auditor of the company, advise the directors in the matter ? Refer to *any two* Case Laws you know in this connection. (B. Com.)

[*Hints* : Only the bounties received from Governmental quarters may be utilised for Dividend payment. The other gains constitute *Capital Profits* and are, therefore, ordinarily to be transferred to *Capital Reserve*. Also, when realised, they may be available for Dividend if certain conditions are fulfilled. For further guidance, please refer to hints on Q. 2.]

5. Write a short note on Divisible Profits dealing with important case law decisions on this subject. (B. Com.)

[*Hints* : By the term *Divisible Profits* should be meant such Profits as could be divided among the shareholders in keeping with the basic Statutory provisions (sections 205, 206 and 207 of the Companies Act), and with the relevant clauses in the Articles of Association. Although the Companies Act does not define precisely, what should be called 'divisible profits', certain broad principles are discernible in it. They have been discussed under hints to Q. 3.

The decisions emanating from lawcourts in some of the following cases should be studied for their historical importance only. It is so said, because the attitude of the Court today, in the light of the various restrictive clauses embodied in the present Companies Act, especially in India, would not be so liberal in the matter of Dividend declaration, as it is noticed to have been in the cases referred to. For instance, some of the case law decisions in the past were in favour of Dividend payment without provision for Depreciation on all of the Assets or without the writing off of past losses. In one case (Lubbock *v.* The British Bank of South America), the Court did not find anything wrong in the distribution of Capital Profit as Dividend when the Articles permitted it. The prescriptions of the Statute and the attitude of the modern courts of law would be found to be altogether different today.

Case Laws : Ammonia Soda Co., Ltd. *v.* Arthur Chamberlain and others.

Bolton *v.* Natal Land and Colonisation Co., Ltd.
Bond *v.* Barrow Haematite Steel Co., Ltd.
Crabtree, Thomas *v.* Crabtree.
Foster *v.* The New Trinidad Lake Asphalte Co., Ltd.
Lee *v.* Neuchatel Asphalte Co., Ltd.
Lubbock *v.* The British Bank of South America.
Stapley *v.* Read Bros., Ltd.
Verner *v.* General and Commercial Investment Trust, Ltd.
Wilmer *v.* McNamara & Co., Ltd.]

6. May a Company write up its Assets in order to recoup past losses ? Consider fully and quote a case in point.

(B. Com.)

[*Hints* : A company may write up its assets in order to recoup past losses. In *Ammonia Soda Co., Ltd.* v. Arthur Chamberlain and Others (1918), the debit balance of

the Profit and Loss Account of the Company was written off by taking into account the appreciation in the value of the company's land as a result of discovery of a new bed of rocksalt. In subsequent years, dividend was distributed without writing off the aforesaid debit balance in the Profit and Loss Account, which the court held valid.

This decision of the Court does not appear to be safe and sound from a commercial point of view and is contrary to the provisions of the Companies Act, 1956.]

7. The Directors of a limited liability Company propose to pay dividends out of a particular year's profits although the Balance Sheet shows a debit balance in Profit and Loss Account on account of previous year's losses.

What is the legal position? Discuss the points on which your answer is to be based. (B. Com.)

[*Hints* : The position is pretty obscure. According to Section 205 of the Indian Companies Act, 1956, no dividend can be paid otherwise than out of Profits of the company. It means that dividend can never be paid out of Capital. Payments of dividend in a case like this can be prevented under the section if it can be proved that such payments have resulted in loss of Capital or have been made out of Capital.

Subject to this basic statutory position, reference should be made to the Company's Articles to see if the relevant clause has anything to say on the point. This apart, certain case law decisions are available for general guidance.

The most important case on the subject is that of Ammonia Soda Company, Ltd. *v.* Chamberlain and others.]

8. The Directors of a Limited Company desire to declare an Interim Dividend. You, as an Auditor of the Company, have been asked to prepare the interim accounts and advise them on the suitability of the measure.

State how you will proceed and narrate briefly the points that will receive your special attention in this connection.

(B. Com.)

[*Hints* : *An Auditor has nothing to do in regard to the preparation of interim accounts. If he does so, he will be doing it as an Accountant.* The legal decisions as laid down in Apfel *v.* Annan Dexter & Co. and in Leech *v.* Stokes will be the guiding principles for an Auditor accepting the above job. Regarding the suitability of the proposal, an Auditor will be well advised to go through the relevant provisions in the Articles, as also to ensure that interim profits are very correctly determined. He should also make it clear to the Directors that in tendering advice, he assumes no responsibility as an Auditor.

The following may constitute a reasonable and safe procedure in respect of interim dividend.

(a) If possible, an interim account is to be prepared by taking Stock and providing for depreciation, bad debts, etc. Otherwise, Gross Profit might be determined on the basis of turnover, where the business is more or less stable.

(b) General conditions of trade during the remaining period should be estimated on a conservative basis and the interim profit be adjusted accordingly.

(c) As an additional safeguard, a fair proportion of the net interim profit should be kept apart to guard against unforeseen deterioration in business.

(d) Payments should be made if the liquid resources of the Company are adequate.

(e) An Auditor should make it clear that if the final profit of the Company is not sufficient to cover the interim dividend already paid, they will be exposed to the risk of paying dividend out of Capital, which runs contrary to the statutory provision.]

9. There is a very large accumulation in the Unclaimed Dividends Account of a Company. The Directors want to transfer this to the Profit and Loss Account for re-distribution as Dividend.

Discuss the soundness of this proposal from the (i) legal and (ii) financial points of view. (B. Com.)

[*Hints* : Legally, the debt is not time-barred before six years under the Law of Limitation. So payment of new dividend from this account might land the company in legal difficulties until such time that it is lapsed or time-barred. Moreover, any such distribution would be

wrong in that it amounts to payment of dividend from Capital Profits.

Financially, the proposition is unsound. This account represents earning of non-recurring nature and has very little to do with the trading result for the year. Moreover, a sudden disbursement of considerable magnitude might affect the liquid position of the business and even fresh commissions may be demanded by the Managing Agents or the Managing Directors. In view of the foregoing, unclaimed dividends outstanding for a long time are generally transferred to a Reserve Account for future contingencies, or are utilised to write off capital losses or preliminary expenses and such other items.]

10. Should the entire amount of 'Net Profits' shown in the Balance Sheet of a Company be distributed as dividend ? State and explain the various considerations that arise in this connection. (B. Com.)

[*Hints* : It all depends upon how the figure of 'Net Profits' is arrived at. Care should be taken to see that all chargeable expenses and losses such as *Depreciation* are duly set off against the current income before arriving at the 'Net Profits'. The question whether the entire amount of 'Net Profits' is divisible or not should be judged in the light of the following considerations :

(a) the nature & extent of the working capital ;
(b) immediate liabilities of the Company and contingent liability, if any ;
(c) liquidity of cash position ;
(d) Taxation ; and
(e) Interim Dividend, if any, already paid.

If the Auditor is satisfied in regard to all the items enumerated above and be sure of the Company's financial soundness, he should not object to the proposed distribution of the entire profits as dividend.]

11. Is a Company bound to replace its lost capital out of current profits before it can declare dividends ? Discuss and explain how far this is required under the Companies Act, 1956.

(M. Com.)

[*Hints* : In Bolton *v.* Natal Land & Colonisation Co., Ltd. case (1892) it was held by the Court that a Company out of its current Profits could declare Dividend without

making provision for the loss in the value of Fixed Assets (such as, Land & Building). Under the *Companies Act 1956 it is obligatory to provide Depreciation on Fixed Assets in the Profit & Loss Account and Dividends cannot be paid without such provision.]*

12. What are Capital Profits ? Can dividend be paid out of such profits ? Discuss. (M. Com.)

[Please refer to hints on Q. 2.]

13. A Company has a large balance to the credit of General Reserve Account built up out of the following :

(a) Appropriation from Profit and Loss Account ;
(b) Profit on sale of fixed assets from time to time ;
(c) Liabilities waived voluntarily by creditors due to the company's financial conditions in earlier years.

The year under review has made a small profit and the Directors desire to recommend the payment of a Dividend involving an amount exceeding the profit of the year. For this purpose they propose to transfer from the Reserve Account sufficient balance to meet the dividend payment.

Consider the propriety of the above proposal.

(Chartered Accountants)

[*Hints* : Only the amount transferred to General Reserve by way of Appropriation from the Profit and Loss Account may be utilised for the payment of Dividend.

Amount transferred from the Profit on the sale of Fixed Assets should not be merged under General Reserve. This amount should be transferred to Capital Reserve Account. Similar ought to have been the treatment for liabilities voluntarily waived by creditors.]

14. The Directors of a Company decide to set aside a substantial amount of the profit of the year to a Contingency Reserve, with the result that no dividend can be recommended on the Preference Shares. Can the Preference Shareholders compel the Directors to pay dividend on their Shares ? Quote legal decision and other provisons in the Act, if any, in support of your answer, presuming that Table A applies to the Company in the present context. (M. Com.)

[*Hints* : It is not obligatory to recommend the payment of Dividend on the Preference Shares every year unless there is such condition in the Articles of Association of the Company. Hence the Directors may set aside a

large amount for a Contingency Reserve if it is necessary. The Preference Shareholders cannot compel the Directors to pay Dividend to them at all eventualities. In *Bond v. Barrow Haematite Steel Co., Ltd.,* it was held by the Court that the Preference Shareholders had no right to claim Dividend out of Current Profits without the provision for Reserves as laid down in the Articles of Association of the Company or as considered necessary by the Directors.]

15. Under what circumstances and to what extent, if at all, is it open to a Company which has written down its assets excessively in the past to write them up, for payment of dividend thereout ? (M. Com.)

[*Hints* : A company may write up the value of its Assets after re-valuation by experts. For example the value of Building may be increased if an expert Surveyor certifies the appreciation after a re-valuation.

It was decided in the case of Ammonia Soda Co., Ltd. *v.* Chamberlain & Others (1918) that a Company might increase the value of its Assets if there was really an appreciation in the value after revaluation, and could distribute dividend out of current Profits without writing off loss of the previous years.]

16. Would you consider that a company could legitimately treat the following as profits avaliable for the purpose of declaring a dividend ?—

(a) Profits used in past years to write down goodwill ;
(b) Past years' profits put to reserve ;
(c) Current profits, without making good the debit balance of the Profit and Loss Account brought forward from the previous year. (M. Com.)

[*Hints* : (a) Profits used in past years to write down Goodwill should not be utilised for the purpose of declaring a Dividend by creating Goodwill Account again and transferring the amount to the credit of a Reserve Account. In the case of Stapley *v.* Read Bros., Ltd., the Company was appropriating profits for some years reducing the value of Goodwill to Nil. Again the value of Goodwill was restored and a Goodwill Account was raised, the Reserve Account being correspondingly credited. Subsequently this Reserve was utilised for the payment of Dividend to Preference Shareholders for three consecutive years.

It was held by the Court that this procedure was correct. But under the Companies Act 1956 this procedure of manipulating the Goodwill Account for Dividend purpose will be wrong.

(b) Past years' profits put to Reserve may be fallen back upon for payment of Dividends.

(c) Current year's Profits cannot be utilised for payment of Dividend without making good the loss of previous years, although in the case of Ammonia Soda Co., Ltd. *v.* Arthur Chamberlain and Others, the Court's decision was contrary to this.]

17. What are the main factors which must be taken into account when considering whether a company may pay dividends to its shareholders ? Summarise four legal cases which establish important principles in connection with divisible profits and dividends. (M. Com.)

[*Hints* : Shrinkage in value of Assets must be written off after all of them have been put to a proper revaluation. Appreciations should be ignored. Fixed Assets should be valued at Original Cost *less* accumulated depreciations and Floating Assets are to be valued at Original Cost or present Market Price, whichever is lower. The contents of the Articles of Association should be carefully studied. To find a more comprehensive answer to the question under review, please refer to hints on similar questions given earlier, quoted from B. Com. papers.

Legal Cases :

(a) In *Lee v. Neuchatel Asphalte Co., Ltd.* (*1889*), the learned judge held that subject to the approval of the Articles, a Company could pay dividend without making good the loss in value of ***Wasting assets.***

(b) In Verner *v.* General and Commercial Investment Trust, Ltd. (1894), it was held that a Trust Company with sanction from its Articles could distribute dividend out of its excess of income over expenditure of the current period, loss of Capital not being recouped.

(c) In Ammonia Soda Co. *v.* Chamberlain (1918). the Court's award was that the existing deficiencies in Paid up Capital *or* the accumulated trading losses need not be met before declaring dividends out of current year's profits.

(d) In Foster *v.* The New Trinidad Lake Asphalte Company, Ltd. (1901), the decision was that the amount realised from Book Debts, earlier written off as irrecoverable, could not be made available for distribution among shareholders unless a surplus remained after a revaluation of the whole of the Assets.]

18. Explain what important legal principles as to divisible profits have been established in any two of the following cases :—

(i) Lee *v.* Neuchatel Asphalte Co., Ltd. (1889, 41 Ch. 1).

(ii) Verner *v.* General and Commercial Investment Trust, Ltd. (1894, 2 Ch. 239).

(iii) Ammonia Soda Co., Ltd. *v.* Chamberlain (1918, I. J. 87, page 193).

(iv) Foster *v.* The New Trinidad Lake Asphalte Co., Ltd. (1901, 1 Ch. 208). (M. Com.)

19. In what circumstances may a Limited Company make a distribution in the nature of a dividend without profits having been earned by the Company ?

What are the respective rights of directors and shareholders in regard to the declaration of dividends ? (M. Com.)

[*Hints* : A Limited Company should not make Dividend payments without earning Profits. If, however, the Company made good Profits in previous years and built up a Reserve for Dividend Equalisation and if the Company holds out a bright prospect for the future, the Directors of the Company may recommend the payment of Dividend by the utilisation of such Reserve. In the absence of Profits, Dividends may also be paid out of moneys provided by the Central Government or a State Government for the payment of Dividend in pursuance of a guarantee given by that Government (sec. 205). The Directors have no right to pay the Dividend unless the Shareholders of the Company at their Annual General Meeting pass a Resolution approving the payment. No Dividend shall exceed the amount recommended by the Board.]

20. The Directors of a Company consult you with regard to the question of payment of an interim dividend. State the points which would guide you in forming an opinion. (M. Com.)

[*Hints* : Before sanctioning the payment of an Interim Dividend, the Directors must arrange for the preparation of an Interim Final Account covering a certain period and adopt this Account at the Board Meeting. The adopted

Final Accounts should be placed before the Auditors for Audit. If the Auditors are satisfied with the financial working and position, they may express an opinion on the desirability of the payment of Interim Dividend, but they should put nothing in writing. The Auditors should express themselves in favour of such payment when a satisfactory trading result is already revealed for the earlier part of the Accounting year and when there is every prospect of a good business for the succeeding months of the year.]

21. Give four examples of profits arising to a Limited Liability Company not through usual course of trading operations and discuss the question of utilising such profits for the purpose of declaration of dividend. (M. Com.)

[*Hints* : Profits of a non-trading character may arise out of the following :—

(a) Profits on forfeiture and re-issue of Shares of a Company.

(b) Profits on the sale of Fixed Assets of the Company.

(c) Profits on the issue of Shares or Debentures at a premium.

(d) Profits on the Redemption of Debentures through purchases in the open market at a discount.

Such profits should not ordinarily be utilised for the payment of Dividends. These amounts should be transferred to Capital Reserve Account to be fallen back upon for the writing off of Capital losses. Please refer to hints on Questions 2 and 5.]

CHAPTER XII

THE AUDITOR OF A LIMITED COMPANY

According to Sec. 224 of the Campanies Act, every Company shall, at each Annual General Meeting, appoint an Auditor or Auditors to hold office from the conclusion of the meeting until the conclusion of the next Annual General Meeting. The First Auditors of a Limited Company are *appointed* by the Board of Directors through a resolution passed by the Board. Such Auditors are to hold office until the first Annual General Meeting. A casual vacancy, caused except through resignation, is also filled up by the Directors. Subsequent Auditors will be appointed by the Shareholders at the Annual General Meeting each year. According to sec. 225 of the Companies Act, Special Notice shall be required for a resolution at an Annual General Meeting appointing as Auditor a person other than a retiring Auditor and on receipt of Notice of such a resolution, the Company shall forthwith send a copy thereof to the retiring Auditor As a matter of professional etiquette, the Auditor appointed in place of another should communicate with the retiring Auditor in writing before accepting the appointment ; otherwise, he will be liable to disciplinary action as per regulations of the Institute of Chartered Accountants in India. Under section 224, there is provision for the Central Government to appoint an Auditor where no Auditors are appointed or re-appointed at an Annual General Meeting. Under section 233A, the Central Government, by an order, may arrange for a special Audit of the Company's Accounts for such period or periods as specified in the order, where in the opinion of the Government, the affairs of a Company are not being administered on sound and healthy lines, or where the financial position of a Company threatens its solvency. The Auditor of a Company, in which more than 51% of the Paid up Share Capital is held by the Government (Central or State or both), will be appointed by the Central Government on the advice of the Comptroller and Auditor-General of India.

The Appointment and Remuneration of Auditors

The remuneration of the Auditor of a Company shall be fixed by the Appointing Authority. The expression "remuneration" will include any sum paid by the Company in respect of the Auditors' expenses.

Qualifications and Disqualifications of Company Auditors

According to sec. 226 of the Companies Act, a person shall not be qualified to act as the Auditor of a Limited Company, unless he is a Chartered Accountant* holding Licence of Practice from the Central Government. If a firm is appointed as Auditors, all the partners of the firm must have the above qualification. The following persons are debarred from being appointed as Auditor of a Company :—

(a) a body corporate ;

(b) an officer or an employee of the Company ;

(c) a person who is a partner to, or who is in the employment of, an officer or an employee of the Company ;

(d) a person who is indebted to the Company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Company for an amount exceeding one thousand rupees ;

(e) a person who is a Director or Member of a Private Company or a Partner of a firm which is the Managing Agent or the Secretaries and Treasurers of the Company ; or

(f) a person who is a Director or the holder of Shares exceeding 5% of the Nominal value of the Share Capital of the Company to come under Audit or of the Share Capital of any body corporate which is the Managing Agent or the Secretaries and Treasurers of the Company.

* A Chartered Accountant is one who has enrolled himself as a member of the Institute of Chartered Accountants in India by passing necessary examinations held by the Institute.

The Status, Rights and Duties of Company Auditors

The Auditors of a Limited Company have the *Status* of an Agent. They, for Audit purposes, shall carefully safeguard the interests of the Shareholders. In another sense, the Auditors enjoy the status of Officers of the Company—they exercise control and superintendence over the actions of the Directors affecting the Shareholders' interests. That the Auditors are officers of the Company under Audit was decided upon in two well-known English cases, viz., *Kingston Cotton Mill Co. Ltd. (1896)* case and *London and General Bank (1895)* case. Under the Companies Act 1956 (sec. 227), as amended subsequently, Company Auditors have a *right* of access to the Books, Accounts, Vouchers and other Documents of the Company at all times and can inspect them, whenever required. Furthermore, they have the right of demanding information and explanations from the Directors to fulfil their part of task. The Company Auditors are also entitled to the following privileges :—

(a) Attending the Shareholders' Meetings wherever their Audited Accounts are placed (notices of these meetings to be sent to the Auditors); and

(b) Participating in discussions over Accounts matters at such meetings.

The most important *duty* of the Company Auditors is to certify the Annual Profit and Loss Account and the Balance Sheet and to report to the Shareholders in the following manner :—

(a) Whether or not they have obtained all the information and explanations they required for the purposes of Audit ;

(b) Whether in their opinion the Profit and Loss Account and the Balance Sheet are properly drawn up in accordance with the law and whether they exhibit a true and fair view of the state of affairs of the Company according to the best of their information and the explanations given to them and as shown by the Books of the Company ; and

(c) Whether, in their opinion, the Books are maintained in keeping with the requirements of Company Law.

Evidently, to be in a position to give a Report on the above lines the Auditors are to go through the Books and Papers sufficiently diligently and not in a haphazard mechanical way. And it shall be the bounden duty of the Auditors to bring to the notice of the Shareholders all frauds, irregularities and discrepancies. An invidious task often devolves on their shoulder.

Removal of Company Auditors

Sections 224 and 225 of the Companies Act deal with tne question of *Removal* of a Company Auditor. An Auditor is liable to be removed from his office for gross misfeasance, incapacity, unprofessional conduct, lunacy or conviction in a Criminal Court of Law. Where at an Annual General Meeting a new Auditor is appointed, Special Notice having been given according to the requirements of sec. 225, that would mean removal of the old Auditor unless he resigned of his own accord. (In this connection please refer to Q. 3(a) along with hints on it given at the end of the present chapter.) According to sub-section (7) of sec. 224, an Auditor may be removed from office before the expiry of his term only by the Company in General Meeting, after it has obtained the previous approval of the Central Government in that behalf.

QUESTIONS ON CHAPTER XII

1. What are the statutory duties of a Limited Company's Auditors? Who may be appointed Auditors of a Limited Company? Under what circumstances, may any of them be disqualified? (M. Com.)

[*Hints* : The duty of an Auditor appointed by a Limited Company is to submit a Report, signed by him, to shareholders on all of the Accounts examined by him. This Report will be accompanied by the Audited Profit and Loss Account and Balance Sheet with the Auditor's views thereon. According to sec. 226 of the Companies Act, a person who is *a Chartered Accountant* and holds *Licence of Practice* from the Central Government can be

appointed Auditor of a Limited Company. If a firm is appointed Auditors for a company, all the partners of the firm must have the above qualifications. A body corporate, or a person having financial interests in the business of a company, cannot act as its Auditor. Sub-sections (3), (4) and (5) of section 226 deal with who shall not be qualified for appointment as Auditor of a Company.]

2. (a) Who can become Auditor of a Public Limited Company ?

(b) How are Auditors appointed in a Public Limited Company ? (B. Com.)

[*Hints* : (a) Please refer to hints on Q. 1.

(b) The first Auditors are to be appointed, by the Board of Directors within one month from the date of Incorporation of the Company, to hold office until the conclusion of the first Annual General Meeting. Subsequent Auditors are appointed by the Shareholders at each Annual General Meeting, to hold office till the next Annual General Meeting. A casual vacancy, if not created by the resignation of the Auditor, can be filled up by the Directors by appointing an Auditor who shall be in office till the conclusion of the next Annual General Meeting. Where no Auditor is appointed or e-appointed at a Company General Meeting, the Central Government would have power to appoint an Auditor. Where, in the opinion of the Government, the affairs of a Company are not being conducted on desired lines, or the management is not going on proper track, the Central Government shall have power to appoint either the Company's Auditor himself, or some other Chartered Accountant (not necessarily to be in practice), to conduct a *Special Audit* as per section 233A. The Central Government will also appoint Auditor for all Government Companies.]

3. (a) How can an Auditor be (i) appointed and (ii) removed under the Companies Act 1956 ?

(b) Under what circumstances can the Central Government appoint Auditors of a Limited Company ? (B. Com.)

[*Hints* : (a) For Auditor appointment, please refer to hints on Q. 2.

With prior sanction of the Central Government, an Auditor can be removed from office, even before the expiry of his term, by the Company in General Meeting (sub-section 7 of sec. 224).

A case of removal will also arise (i) where the first Auditor appointed by the Board is not re-appointed at the first Annual General Meeting of the Company, and (ii) in the case of a subsequent appointment if a new Auditor is appointed in place of his predecessor or if no Auditor is at all appointed. Special Notice shall be required in these cases as laid down under sec. 225 (i).

(b) For Central Government's power to appoint Auditor of a Limited Company, please refer to hints on Q. 2.]

4. Examine the status, rights and duties of a Company Auditor.

5. The Directors of a Public Limited Company have decided to make a change of Auditors and have asked you to accept the appointment.

(a) State the steps you would take : (i) before accepting the appointment ; and (ii) before commencing the Audit.

(b) Would you take indentical steps if the Company were a Private Limited Company ? (M. Com.)

[*Hints* : (a) Where a new Auditor is appointed in place of the retiring one, the former has to communicate with the latter in writing *before accepting* the appointment, as a matter of professional etiquette as demanded by the regulations of the Institute of Chartered Accountants in India. Non-compliance of this may find the new incumbent open to disciplinary action.

Before commencing the Audit, the newcomer should always make it a point to verify the *authenticity of his appointment.* And the appointment would be deemed to be regular, if according to sections 224 and 225 of the Companies Act the following were done :—

(i) Within *seven* days of the appointment intimation was given by the Company ito the newly appointed Auditor.

(ii) Within *thirty days* of the receipt from the Company of the above intimation, the Registrar of Joint Stock Companies was duly informed of the acceptance of the appointment.

(iii) For the Annual General Meeting Resolution passed in favour of the appointment, Special Notice was received by the Company, and it was communicated to all the Shareholders, and a copy thereof was forthwith sent to the retiring Auditor.

(iv) If any representations were made in writing by the retiring Auditor in time, a copy thereof was sent to every Member of the Company, or, time not having permitted, these were at least allowed to be read out at the Meeting.

Furthermore, always the Auditor would do well to obtain and scrutinize the duly attested copy of the Appointment Resolution and check it by reference to the Minute Book, or if matters are not ready there, by reference to the Proceedings Book.

(b) The Companie Act does not make any distinction between a Public Limited Company and a Private Limited one in regard to the requirements of professional courtesy or of law as discussed under (a).]

6. A Company wants to appoint an Auditor in place of the one appointed by the last Annual General Meeting.

What steps should be taken by (i) the Company, and (ii) the Auditor, in order to give effect to this in compliance with the provisions of the Indian Companies Act? Distinguish between the cases where there is a casual vacancy and where there is not.

(B. Com.)

[*Hints* : Please refer to hints on Q. 5. To appoint a new Auditor in place of the retiring one, a *Notice* nominating the new Auditor should be given by any Member of the Company at least *fourteen days* before the date of the Annual General Meeting.

The stringencies of law to be observed, when a new Auditor is appointed in place of the old one, will apply, only where the predecessor had his appointment at the last Annual General Meeting, and was not chosen by the Directors to fill in a casual vacancy.]

7. State the rights of the Auditor under the Companies Act, 1956 regarding :—

(a) The Statutory Books of a Company ;
(b) Meeting of a Company ;
(c) Accounts of a Branch Office of a Company.

[*Hints* : (a) Every Auditor of a Company shall have a right of access, at all times, to the Accounts, Vouchers and all Statutory Books of the Company, whether kept at the Head Office or elsewhere (sec. 227).

(b) An Auditor has the right to receive Notice of, and attend, any General Meeting in which Accounts audited by him are placed. He shall also be entitled to express himself freely, at a General Meeting, on any part of the business which concerns him as Auditor (sec. 231).

(c) Where a Company has a *Branch Office*, the accounts of that office shall be audited by the Company's Auditor, or by a person qualified for appointment as Auditor of the Company. If the Accounts of a Branch are audited by a person other than the Company's Auditor, the Head Office Auditor shall have a right to visit the Branch, and conduct a full Audit of all the Books maintained at the Branch for incorporating the Branch transactions into Head Office Books. This does not apply in the case of a Banking Company having a Branch Office outside India, where the Auditor may accept the Branch Returns signed by the Branch Manager instead of visiting the Branch for Audit purpose (sub-sections (1) and (2) of sec. 228). Here the Auditor will have access to such copies of, and extracts from, the books and accounts of the Branch as would be transmitted to the Principal Office of the Company in India.]

CHAPTER XIII

THE AUDIT OF A LIMITED COMPANY

The first Auditors of a Company, i.e., those appointed at the stage of Company formation, are to obtain from the Secretary of the Company a certified copy of the Board Resolution on the appointment of Auditors. Auditors subsequently appointed must get a certified copy of the Shareholders' Resolution to verify the regularity of their appointment. According to sub-section(1A) of sec. 224 of the Companies Act, every Auditor, unless he is a retiring Auditor, shall, within thirty days of the receipt from the Company of the intimation of his appointment, inform the Registrar of Companies in writing that he has accepted, or refused to accept, the appointment. Where an Auditor is appointed in place of the retiring Auditor, the new Auditor should see that he has been informed of his appointment within seven days of the passing of Resolution. Before commencing Audit, the Auditor should see, in accordance with sec. 215 of the Companies Act, that the Balance Sheet and Profit and Loss Account with supporting Schedules of the Company are properly authenticated. Authentication, here, means that the Final Accounts along with the supporting Schedules shall be signed on behalf of the Board of Directors, after the Directors' meeting has approved the Accounts, by the Managing Agent or the Secretaries and Treasurers or the Manager and at least two Directors one of whom must be the Mg. Director, if any. The Auditors will then visit the Registered office of the Company and draw up a suitable programme of the Audit. At the very outset, the following Documents are to be studied carefully and thoroughly :

The first things to be done by Company Auditors

(a) *The Memorandum of Association* (the Object Clause* to be specially scrutinized) ;

* The Object Clause of the Memorandum shall mention the State or States to whose territories the objects, with the exception, however, of trading corporations, will extend.

(b) *The Articles of Association* (particularly, the mode of Share Capital issue and the Remuneration for different Managerial Bodies) ;

(c) *The Prospectus* (with particular stress on the amount of Share Capital proposed to be issued, Minimum Subscription and the Amounts payable on Application. Allotment and Calls) (not applicable for Private Companies) ;

(d) *The Contracts with Vendors in connection with the purchase of Assets and with other persons for payment of Commission, Brokerage or Preliminary Expenses* (when the Contract is with Vendors, special regard should be paid to payment of purchase consideration and when the Contract is over matters like Commission, Brokerage, etc., regard should be paid to the nature and the rates of such charges and in case of Preliminary Expenses, it should be seen that the Expenses have all been within permissible limits) ;

(e) *The Balance Sheet and the Auditor's Report of the previous year* (to see that the last Auditor's Report has been a clean and unqualified one).

Professional etiquette demands that a Courtesy Letter will be written by the newly appointed Auditor to the previous Auditor, the latter being informed of the former's appointment. And Professional conduct demands that the existing Audit Fees be not curtailed. Before commencing regular Audit the following Statutory Books must be inspected :

(i) Investments Register (particularly, the details of Shares, Debentures and other Securities in which Investments have been made and in whose names the Securities are held) ;

(ii) Mortgage Register (Details of charges on Company's properties and the description of properties and names of Mortgagees to be especially examined and the amount, the rate of interest and the limit of the Loan to be especially noted) ;

(iii) Members' Register with Index (names, addresses and occupations of the shareholders and their holdings with distinctive share nos. and amounts paid on the shares to be particularly seen)—this Register will give the total amount received from Sundry Members by way of Subscribed Capital ;

(iv) Debentureholders' Register with Index (the matters to engage the attention of the Auditors are : names, addresses and occupation of the Debentureholders, their Holdings, with serial nos., the amounts paid on the Holdings and the rate of interest) ;

(v) Copy of the last Annual Return (the summary of the Share Capital and the Debentures to be especially seen—also to be seen, list of past and present Shareholders and Debentureholders and the particulars of Directors, Mg. Agents or other Managerial Bodies, past and present) ;

(vi) Minute Books of the Directors and the Shareholders (with particular stress on Resolutions in connection with allotment, calls and forfeiture of Shares, Approval of Final Accounts, Appropriation of Profits and proposed Dividends so for as the Directors' Minute Book is concerned ; in the Shareholders' Minute Book, the matters to pay particular attention to are : Approval of Directors' and Auditors' Reports on the Final Accounts, Declaration of Dividend, Election of Directors by rotation, Appointment and Remuneration of Auditors) ;

(vii) Contract Register (especially to be noted down are : names of parties, dates of the contracts, conditions of the contracts and the Board Resolutions confirming the contracts) ;

(viii) Register of Managing Agents, Directors or Secretaries and Treasures (Matters for particular examination : names, addresses and occupations of the Directors and other Managerial Authorities and the dates of birth of the Directors) ;

(ix) *Directors' Register of Shareholdings* (particular attention to be paid to: names, addresses and occupations of the Directors, their Holdings with distinctive nos. and the amounts paid on the Holdings—whether, according to the Articles, qualification shares have been taken up by the Directors is to be scrutinized) ;

(x) Managing Agents' Register of Contracts (Matters to be especially seen : terms and conditions of the Appointment of Mg. Agents and particulars of their buying and selling contracts, if any) ;

(xi) Register of Investments in Managed Companies (particulars of the Investments made in companies under the same Managing Agents to be especially seen).

Apart from inspecting the above Statutory Books, it will be a must for the Auditors to go through all of the Financial Books, such as Cash Book, Journal, Ledger, etc., and the following Statistical Books :—

Share Application and Allotment Book ;
Share Call Book ;
Share Transfer Register ;
Debentureholders' Application & Allotment Book ;
Debentureholders' Call Book ;
Shareholders' Dividend Register ;
Debentureholders' Interest Register ;
Shareholders' and Directors' Attendance Book ;
Register of Sealed Documents ; and
Register of powers of Attorney.

Having completed a first hand inspection of the above documents and books, the special points are to be recorded for ready reference in a working file to be separately opened for each company under Audit.

SHARE CAPITAL AUDIT

Certain General Considerations. For conducting Share Capital Audit, from the Articles of Association is to be seen what the amounts of Preference Share Capital and Equity Share

Capital are. The total number of shares into which the two Capitals have been divided and the manner and mode of payment at different stages (viz., at the time of Application, Allotment and subsequent Calls) and the Minimum Subscription to be raised before proceeding to allotment are to engage the pointed attention of the Auditors. According to sec. 87 of the Companies Act, every member of a Company Limited by Shares and holding any Equity Share Capital therein shall have a right to *vote* on every Resolution placed before the Company. His Voting Right on a poll shall be in proportion to his share of the paid-up Equity Capital of the Company. A Preference Shareholder shall have a right to vote only on Resolutions placed before the Company which directly affect the Rights attached to the Preference Shares. Under sec. 88 of the Companies Act, no Company shall issue any Shares which carry *Voting Rights* or *Rights as to Dividend* which are disproportionate to the Rights attaching to the holders of other shares (not being Preference Shares). Ordinarily, a small part of the total amount payable on a Share is asked for being paid at the time of application. Companies will authorise some scheduled Bank to receive the Application Money, together with the Application form duly filled in, from the Applicants direct. The Bank next morning forwards to the Company's Registered Office a statement of the amounts received from different applicants along with the original applications from parties. The Auditors' duty shall be to check up these applications and to see whether they have been entered into the Application and Allotment Book with names of the applicants and the amounts received. Also they should unfailingly check up whether the amount shown in the Banker's Daily Statement as the total Application Money received appears on the debit side of the Cash Book under Application Account, duly agreeing with the daily total of the Application Column of Application & Allotment Book. After the shares have been subscribed, the Auditors are to be satisfied that the total amount receivable on account of application as per Articles of Association appears on the credit of Application Account in the Ledger.

Application Stage. Under sec. 69 of the Companies Act, the amount payable on Application shall not be less than 5 per

cent. of the Nominal value of the Shares applied for. According to the same section, if the Minimum Subscription is not raised or received on the expiry of 120 days after the first issue of the prospectus, all amounts received from the Applicants for Shares shall be repaid to them without interest. If the money is not refunded within 130 days after the date of issue of the Prospectus, the Directors of the Company shall be jointly and severally liable to repay the amount with interest at the rate of 6 per cent. from the expiry of the 130th day. Moneys received from Applicants have also to be refunded where it was stated in the Prospectus that Shares and Debentures of the issuing Company would be dealt in on Stock Exchange, but subsequently the permission for enlisting the instruments has not been applied for to the Stock Exchange Authorities or has not been granted by them. In this connection the Auditor should be conversant with sec. 73 of the Companies Act.

Allotment Stage. The validity of the Allotment of Shares will be checked up from the Directors' Resolution recorded in the Directors' Minute Book and from the record made in the Application and Allotment Book duly signed by the Chairman of the Board of Directors. The Auditors should also examine the Journal Voucher duly passed by at least one Director transferring the Application money to Share Capital and debiting Allotment Account and crediting Share Capital Account with the total amount receivable on Allotment. The Bank Statement will then be checked up with the debit entries in the Cash Bank and corresponding credit entries in the Allotment Account of the Ledger and with the entries in the Allotment column of the Application and Allotment Book. On allotment of Shares, the Company enters into a contract, enrolling the subscribers as Members. It has, therefore, to be checked up whether after the allotment money is received the shareholders' names have been made to appear in the *Shareholders' Register* or (*Members' Register*) with particulars of Shares allotted and amounts received.

After the allotment money is received, Share Certificates (Scrips) should have been issued to Members. The Auditors are to examine counterfoils of the Share Certificates along with entries in the Share Ledger.

Call Stage. Letters of call are to be issued on the strength of Board's Resolution which the Auditors should peruse along with the Journal Voucher debiting the particular Call Account and crediting the Share Capital Account. When call money is realised, that is to be checked up with the Banker's Statement and entries in the Cash Book, Ledger and Members' Register. If Bonus Shares* are in issue the Auditors should trace the source from which such Shares were issued. Also the Directors' Resolution (recommending the issue), the shareholders' Resolution (passing the issue), the sanction of the Articles of Association and the approval of the Central Government regarding the issue of Bonus Shares are to be duly examined. If Shares are issued as fully or partly paid up for a consideration other than Cash, the Auditors should see the Articles of Association authorising such issue and the Directors' Resolution in this connection. The vendor's Agreement with the company is to be taken into examination with special stress on the terms of settlement of the Purchase consideration.

Issue of Shares at a Premium. If Shares were issued at a premium under sec. 78 of the Companies Act, the Auditors should see that the premium money stands to the credit of "the Share Premium Account". It has to be seen that this money is applied only for writing off the Preliminary Expenses of the company, or for writing off losses of capital nature as mentioned in the section quoted above, or for paying up unissued Shares of the Company to be issued to Members of the Company as fully paid Bonus shares.

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* Bonus Shares are Shares issued to the existing shareholders of the Company. For these shares no payment is required to be made. Such issue is done by making available to the members of the Company a part of the past undistributed profits lying at the credit of Reserve Accounts. Thus what was withheld from the shareholders in the past is now brought to them in the shape of instrument which may be retained for future Dividends or may be converted into liquid cash any time. Bonus Shares may also be issued against the Company's current Dividend liability, the Companies Act allowing Dividend payment either in cash or by issue of Bonus Shares. The Company thus has an increase in its working capital and the shareholders enjoy the benefit of an appreciable increase in the value of their holding.

Issue of Shares at a Discount. According to Section 79 *of the Companies Act 1956, Shares may be issued at a Discount provided the following conditions have been fulfilled :*

(a) The same class of shares must have already been in issue ;

(b) At least one year must have elapsed after commencement of Business of the Company ;

(c) The shares must be issued under a Resolution passed by the Company in general meeting and under sanction from the Court (the issue must be completed within two months from the date of the court's sanction) ;

(d) Unless there is special sanction from the Central Government, the rate of Discount cannot be more than 10% of the nominal or face value of the shares ;

(e) Particulars of the Discount must be mentioned in every prospectus relating to the issue of the Shares. In all cases of Shares issued at a Discount, the Auditors should see that the provisions have all been observed.

Underwriting Commission and Brokerage. According to section 76 of the Companies Act 1956, underwriting commission or Brokerage may be paid on the issue of Shares and Debentures The following should engage the attention of the Auditors :— Contents of the Prospectus in this connection, sanction of the Articles of Association and the contract with Underwriters or Brokers. An Underwriter gives *guarantee* for the sale of a certain nnmber of shares. If the stipulated amount of shares cannot be made to be sold to public, the Underwriter himself is to subscribe for the balance. A Broker does not give any guarantee for the sale of shares. The rate of underwriting commission or of brokerage cannot exceed 5% of the nominal value of the Shares or 2½% of the nominal value of the Debentures.

Forfeiture of Shares and Re-issue of the Forfeited Shares. Due to nonpayment of Call Moneys, if Shares are forfeited, the Auditors should see the following :

Authority in the Articles of Association, Directors' Resolution and entry in the Members' Register. The same things are to be inspected when the forfeited shares are re-issued. If the money collected on re-issue has been taken to the debit of Cash Book is also to be verified. Forfeited Shares must not be issued at a price which, together with the amount already realised on the previous issue, falls short of the Nominal Value of a Share.

Different Kinds of Shares. Under the latest Companies Act, Shares are of two categories : (a) *Equity Shares* and (b) *Preference Shares.* Equity Shares, popularly known as Ordinary Shares, have an equitable treatment in the matter of Dividend payment and in the matter of Capital Repayment on liquidation of the Company, whereas Preference Shares will have a prior claim in both respects. The nature of preferential treatment will be indicated in the Articles of Association and in the Prospectus of a Public Limited Company. Preference Shares are cumulative when the dividends of a year, which cannot be declared for lack of adequate profits, accrue and are carried forward. Such carrying forward for payment in some subsequent year is not permissible in the case of Non-Cumulative Preference Shares. Preference Shares may also be issued as Redeemable under sec. 80 of the Companies Act 1956, subject to the provisions of the Articles of Association. Capital will be refunded to the holders of such shares after a specified time as indicated in the Articles of Association. According to section 81 of the Companies Act, if a Company proposes to increase the Subscribed Capital by allotting further shares, at any time after the expiry of two years from the formation of the Company, or at any time after the expiry of one year from the first allotment of Shares, whichever is earlier, the Company shall first offer the Shares to the already enrolled Members in proportion to their paid-up Capital. When they decline the offer. the new Shares will be allotted to others.

The Redemption of Redeemable Preference Shares. This will not amount to any reduction in Share Capital and will be done either out of a fresh issue of shares done for the purposes of

redemption, or from out of accumulated sums set apart from the divisible profit with that end in view. If the latter course is to be followed, at the year-end, the Profit and Loss Account will be debited by way of appropriation and correspondingly the Capital Redemption Reserve Fund Account will be credited. The undrawn profits thus set apart is to be invested outside the business in 'Approved' Securities. When the Redeemable Preference Shares are ripe for redemption, repayment of money is allowable only if the shares have been fully paid up. At this stage, the ear-marked securities will be disposed of and the proceeds utilised for the repayment purpose. Sometimes, the Redemption is to be done at a premium. The premium money, then, has to be procured from out of the profits of the Company or out of the Company's Share Premium Account. After repayment of Capital, the credit balance of the Capital Redemption Reserve Fund Account will be transferred to Capital Reserve Account and this may be applied by the Company, in paying up unissued shares of the company to be issued to the existing shareholders as fully paid up Bonus Shares.

Share Warrant. Under sec. 114 of the Companies Act, a Public Company, Limited by Shares, if so authorised by its Articles, may, with the previous approval of the Central Government, with respect to any fully paid up Shares, issue, on the requisition or application from a shareholder, under its common seal a Warrant stating that the bearer of the Warrant is entitled to the Shares therein specified. This is called *Share Warrant*. The holders of these Warrants are eligible for future dividends on the Shares specified in the Warrant. The Shares may be transferred by delivery of the Warrant. Under sec. 115 of the above Act, on the issue of a Share Warrant, the Company shall remove from the Register of Members the name of the shareholder against whose Shares the Share Warrant has been issued, as if he has ceased to be a Member. In the above Register are now to be entered the following particulars : (a) the fact of the issue of the Warrant, (b) a statement of the Shares specified in the Warrant with their distinctive numbers, and (c) the date of issue of the Warrant. The bearer of a Share Warrant shall, if the Articles of the Company so

provide, be deemed to be a Member of the Company for participating in the Dividends when, on payment of necessary fee, the Share Warrant is surrendered to the company for cancellation and for making his name appear in the Members' Register as a Member. The Auditor will examine whether the provisions of sections 114 and 115 have been duly complied with when a Share Warrant is issued or, after issue, when it is cancelled.

Conversion of Shares into Stock. According to sec. 96 of the Companies Act, where a Company having a Share Capital has converted any of its Shares into *Stock* and given notice of such conversion to the Registrar within one month after doing so (in accordance with Sec. 95), all the provisions of the Companies Act which are applicable to Shares only shall cease to apply of the Share Capital converted into Stock. The difference between Stock and Shares shall be as follows :—(a) Stock must be fully paid-up but Shares may be partly paid up ; (b) Stock is issued or transferred in fractional parts, if desired, whereas Shares cannot be issued or transferred in fractions. For example, one thousand Equity Shares of Rs. 10 each with distinctive nos. 2001-3000 may be converted into Stock numbering 5 on the requisition of the holder of the above Shares or on an Ordinary Resolution having been passed at the Annual General Meeting, converting Shares into Stock. If the holder of Stock no. 5 now so desires, he may part with any fraction of his possession.

Transfer of Shares. Under sec. 108 of the Companies Act. the transfer of Shares of a Company has to be registered. An Instrument, known as Transfer Deed, must be presented in prescribed form before the Registered Office of the Company, duly stamped and signed (in the presence of witness) by the transferor and the transferee. The clauses regarding transfer in the Articles of Association or in Table 'A' (Rules concerning the internal management of a company limited by Shares in the absence of the Articles, framing an Appendix to the Companies Act) are to be examined by the Auditors. The signature should be verified from the original application of the transferor if he is the original shareholder, otherwise from

the Transfer Deed. The Directors' Resolution on the transfer *should be examined and the change in the Share Ledger in connection with the transfer cancelling the name of the transferor* and entering the name of the transferee should also be seen. It should be noted that whenever a Transfer Deed is registered, the Company must give Notice of Transfer to the Transferor and wait for at least a fortnight to see whether he has got any Objections prior to the execution of the transfer.

Blank Transfer. To obtain advances from the Bank, or sell Shares at the Stock Exchange, Blank Transfers are often taken resort to. By Blank Transfer is meant that the Transfer Deed is signed by the transferor or seller of the Shares only while the name of the buyer or transferee and the date of the Execution are kept blank. Share Certificates are to be enclosed to the Transfer Deed, so that in the event of the non-payment of the advance by the Transferor, the Bank has a right to put its name as buyer on the Transfer Deed and sell the Shares to recoup the advance. In the case of Stock Exchange transactions relating to Blank Transfers, Shares may pass from hand to hand till a Holder in Due Course, if he so desires, will put his name on the Transfer Deed and register his name with the Company as Shareholder to participate in future dividends.

Transmission of Shares. When a shareholder dies, his legal representatives or beneficiaries become entitled to the ownership of the Shares. The process of change of this ownership is known as Transmission of Shares (vide Articles 25-28 of Table A). Where the deceased member was a joint holder, the survivor or the survivors shall be recognised as heir to the interest in the Shares, the Controller of Estate Duty being notified of that. On the death of a shareholder when an application for change of Ownership of Shares is submitted by the Executor to insert the name of the beneficiary in place of the deceased shareholder, the Auditor should see the Letter of Probate* and Succession Certificate in order to verify the name of the beneficiary. The provisions of the Articles, the

* Official proving of Will.

Directors' Resolution, Share Register and Register of Probates should also be seen in this connection. The Share Certificates must also be endorsed accordingly with the common seal of the Company. Any person becoming entitled to a Share in consequence of the death or insolvency of a Member may elect (i) to be registered himself as holder of the Share ; or (ii) to make such transfer of the Share as the deceased or insolvent Member could have made. In the latter case, the Auditor will go through the procedure of Share Transfer Audit. The Articles may provide for the payment of fees for registration of a transmission. And, in that case, the Auditor will check the realisation of fees.

Reduction of Share Capital. Under sec. 100 of the Companies Act, a Company, limited by Shares, may, if so authorised by its Articles, reduce its Share capital by a Special Resolution, subject to confirmation by the Court in the following manner : (a) by extinguishing or reducing the liability on any kind of its Shares in respect of Share Capital not paid up—for instance, if Rs. 3 is still not called up on a ten-rupee Share, this uncalled amount may be extinguished totally or reduced to, say, Re. 1 ; (b) by cancelling any paid-up Share Capital which is lost or is unrepresented by available assets—for example, when there is a huge debit balance of Profit and Loss Account, it may be wiped off by reducing the Nominal as well as the Paid-up value of Equity Shares, say, from Rs. 10 to Rs. 5 each ; (c) by paying off any paid up Share Capital which is in excess of the requirements of the Company—for example, if the total amount of Equity Share Capital is Rs. 1,50,000 which is considered by the Directors to be fifty per cent. in excess of the requirements of the Company, a sum of Rs. 50,000/- may be paid off to the shareholders by debiting Share Capital Account and crediting Bank. Whenever any Reduction of Capital takes place, the Auditor should see the following : sanction of the Court, Directors' Resolution recommending the Reduction Scheme and Shareholders' Special Resolution approving the Reduction, authority in the Articles, changing of the Memorandum (Capital clause) and the mention of the words 'and reduced' in the body of the Company's name if so ordered by the Court till the expiry of a specified period.

Miscellaneous Changes in the Share Capital Structure. A Company, limited by Shares, if so authorised by its Articles of Association, may change the conditions of its Memorandum without the Court's sanction in the following manner :

(a) Increasing the Share Capital by the issue of new Shares ;

(b) Consolidation of its Share Capital by converting Shares of small denominations into those of high denominations ;

(c) Conversion of paid-up Shares into Stocks and re-conversion of such Stock into paid-up Shares.

Interest Payable out of Capital During Construction. Under sec. 208 of the Companies Act, where any Shares in a Company are issued for the purpose of raising money to meet the expenses of the construction of any Project or Plant, interest may be allowed to be paid out of Capital on fulfilment of the following conditions :--

(i) The Articles should have sanction for such interest payment, or Special Resolution should be passed at the shareholders' meeting sanctioning the payment.

(ii) The Central Government should give consent to the interest payment.

(iii) The rate of interest shall in no case exceed 4 per cent. per annum or such other rate as the Central Government may direct.

(iv) The payment of interest shall be made only for a period which shall in no case extend beyond the close of the half-year next after the half-year during which the work has been actually completed or the Plant provided. For example, if the construction work is completed some time during the half-year ended 31st December 1960, interest will be paid up to a date not beyond 30th June 1961.

DEBENTURE AUDIT

Meaning and Scope of a Company Debenture. A Debenture is an instrument issued by a Company in acknowledgement of its debt to the holder. Interest at a fixed rate is to be paid by the Company for the loan raised through the issue of a Debenture. The rate of interest and other terms of issue and redemption of this Loan are embodied in the instrument. Debentures do not carry voting rights at any meeting of the Company.

Different Classes of Debenture. Debentures may be *Mortgage Debentures*, as opposed to *Simple* (*or Naked*) *Debentures*. The latter has no charge on any property of the Company for its failure to comply with the terms of the instrument. The holder of a Mortgage Debenture, on the other hand, will attach the property mortgaged behind the issue of the instrument in case the Company fails to fulfil its obligations. Mortgage Debentures may again be of two types : (i) *Fixed* Mortage Debentures (or Mortgage Debentures with a Fixed charge on the Company's Asset mortgaged); and (ii) *Floating* Mortgage Debentures (or Mortgage Debentures with a Floating charge on the Company's Property). In the case of the former, prior consent of the lending person has to be obtained before any material change or alteration can be made on the Asset. The holder of a Floating Mortgage Debenture will not, however, have any say in similar circumstances. According to sec. 120 of the Companies Act, Debentures may be issued with a condition to make it *Redeemable* on the expiry of a certain period or *Irredeemable*. The holders of Irredeemable Debentures, also known as Perpetual Debentures, are to wait until liquidation of the Company for getting back the money lent. Those that hold Redeemable Debentures will, on the other hand, be repaid by the Company on a stipulated date as stated in the body of the Debenture. To provide for the Redemption, a Fund styled as Debenture Redemption Fund will be created through the Annual Appropriation of Profits, and after redemption, the credit balance of this Fund Account will be transferred to General Reserve. The money set apart from the Profits should be invested in Gilt-edged Securities, and when it is time for

Redemption, the Securities would be disposed of, and the sale proceeds utilised in paying off the Debenture holders. A distinction may be observed between *Registered Debentures* and *Bearer Debentures.* The names of the holders of Registered Debentures will appear in the Book (Debenture Register) of the Company, whereas the names of those that hold Bearer Debentures are not registered in the Books of the Company. Bearer Debentures may be transferred from one owner to another by mere delivery (no endorsement is necessary). Registered Debentures, on the other hand, are not transferable by mere delivery. The transferor has to surrender his instrument to the Company and a Transfer Deed is to be executed as in the case of Share Transfer, if the transfer of a Registered Debenture is desired.

Debentures Issued as Collateral Security for a Loan. When a Loan or Overdraft is taken from a Bank, some Securities are to be lodged. If additional Securities are wanted, Debentures may then be issued by the borrowing Limited Company to the Bank for the purpose. Such Debentures are known as *Debentures issued as Collateral Security.*

Auditor's Duty as to Debentures. The Auditor's first task in respect of Debenture Audit is to see whether the Articles of Association gives the Company borrowing power for issuing Debentures. On the issue of Debentures the full particulars of the instrument including the total amount of issue, the nature of interest payment and all the terms and conditions of issue and redemption have to be drawn up with the assistance of a lawyer or a Solicitor on a Document and this is to be duly registered at the appointed office of Registration. This document, called *Debenture Trust Deed,* must be presented before the Auditor for his examination. The procedure for checking issue, transfer and other matters of Debentures will be similar to Share Capital Audit. Certain special points are, however, to be noted as indicated below :

(i) Where Mortgage Debentures are in issue, the Register of Charges should be inspected ;

(ii) Where the Company has re-issued the same Debentures as were redeemed, the Auditor should inquire

whether the Company has power to re-issue Redeemed Debentures under sec. 121 of the Companies Act ;

(iii) Where Debentures have been redeemed, the Auditor will check up each case of redemption by asking for the returned Debenture Bonds and the Receipts from parties to whom moneys were paid on repayment of the debt ;

(iv) Where Debentures are in issue as Collateral Security for a Loan, the Auditor should examine the contract with the lender and the Board Resolution on the Debentures being thus issued. Besides, he should see that the Balance Sheet makes a mention of the issue as a note against the particular Loan to provide for whose additional Security the Debentures have been so issued and that the issue of these Debentures has been recorded in the Register of Debenture-holders distinctly and separately from the issue of ordinary Debentures.

THE STATUTORY AUDIT

According to sec. 165 of the Companies Act, every Public Company having a Share Capital shall, within a period of not less than one month nor more than six months from the date the Company is entitled to commence business, hold a General Meeting of the Members of the Company. This meeting is called the Statutory Meeting. The Board of Directors shall at least 21 days before the meeting forward a report called Statutory Report to every Member of the Company. The Statutory Report shall contain the following :—

(i) Total number of Shares allotted distinguishing Shares allotted as fully or partly paid up for considerations other than Cash from Shares issued in lieu of Cash.

(ii) The total amount of Cash received by the Company in respect of all shares allotted.

(iii) An abstract of Receipts and Payments of the Company up to a date within seven days of the date

of the Report. The receipts of the Company from Shares and Debentures are to be shown separately from the receipts from other sources. Also will be given in the body of the Report an account or estimate of the *Preliminary Expenses** of the Company, showing separately any Commission or Discount paid or to be paid on the issue or sale of Shares or Debentures.

(iv) The names, addresses and occupations of the Directors, Auditors, Managing Agent, Secretaries & Treasurers, Manager and Secretary of the Company.

(v) The particulars of any contract (*with vendors* from whom business Assets may have been purchased by the Company or *with underwriters* who extend the guarantee of selling a stipulated amount of shares or *with persons like the Directors, the Managing Agent, etc.*) which is to be submitted to the meeting for its approval. If any contract has been modified or is proposed to be modified, the particulars of the modification or proposed modification should be given in this clause of the Statutory Report.

(vi) The arrears, if any, due on calls from the Directors, the Mg. Agent, the Secretaries and Treasurers and etc.

(vii) The extent, if any, to which Underwriting Contract has not been carried out and the reasons thereof.

(viii) The particulars of any Commission or Brokerage, paid or to be paid in connection with the issue or sale of Shares or Debentures to any of the persons on management as described earlier.

* *Preliminary Expenses* mean expenses incurred at the stage of Company formation. The cost of printing and issuing documents like the Memorandum, the Articles and the Prospectus and Letters of Application, Letters of Allotment and Letters of Call constitute the Preliminary Expenses of a Company. Preliminary Expenses would also include Registration fee payable by the Company and various legal charges to be paid at the initial stage of company floatation.

The Statutory Report shall be certified as correct by not less than two Directors of the Company one of whom should be a Mg. Director, if any. The Auditor will certify the Statutory Report as correct so far as these matters only are concerned :

(a) the Shares allotted by the Company ;

(b) the Cash received in respect of the Shares allotted ; and

(c) the Receipts and Payments of the Company on Capital Account.

And in this respect the Auditor will go through stages as discussed under Share Capital Audit and other earlier sections of this chapter. The Auditor is further to see that all the requirements of the Companies Act relating to Statutory Meeting have been duly complied with. For instance, a copy of the Statutory Report was duly sent to the Registrar of Companies and to every Member of the Company along with due Notice. It has to be noted that the Statutory Meeting is not to be held by a Private Limited Company.

CERTAIN SECTIONS OF THE COMPANIES ACT 1956, AS AMENDED SUBSEQUENTLY, WHICH ARE OF PARTICULAR IMPORTANCE FOR THE AUDITOR

Mode of forming an Incorporated Company. Under sec. 12 any seven or more persons associated for any lawful purpose may, by subscribing their names to a Memorandum of Association, and complying with the requirements of the Companies Act in respect of registration, form a Public Limited Company. In the case of a Private Limited Company two or more persons will be required to constitute it. Sections 33 and 34 say that a Certificate of Incorporation would be issued by the Registrar of Companies when the Memorandum and the Articles of a Company (accompanied by other documents* as

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* The following further documents should also accompany the Memorandum and the Articles when Registration is applied for :

(*i*) the Managing Agency Agreement or Agreement with Secretaries and Treasurers, if any ;

prescribed under the Companies Act) have been registered and when the Registrar is satisfied that all the requirements of the Companies Act in respect of registration have been duly complied with.

Authentication of Documents and Proceedings. Under section 54 Documents or Proceedings requiring authentication by a Company may be signed by a Director, the Mg. Agent, the Secretaries & Treasurers, the Manager, the Secretary or some other authorised officer of the Company, and need not be under its common seal.

Issue of Prospectus by a Public Limited Company. Sections 55-68 of the Companies Act deal with the question of *Prospectus.* All Public Limited Companies are to issue a Prospectus or a Statement in lieu of Prospectus thereby inviting the public to invest their money in the Company's Shares or Debentures. Prospectus is thus an invitation for buying Securities of the issuing company. This document, to be printed in booklet form and also to be published in the leading newspapers, will contain all such information as are ordinarily inquired about by a prospective investor The Companies Act prescribes severe penalties for any wrong or misleading statement in the Prospectus of a Company. And the punishment will be inflicted on those that are responsible for the drafting and publication of the document. Before the Prospectus is issued, a copy thereof must be delivered to the Registrar of Companies for registration, signed by every person who is named therein as a Director, or proposed Director, of the Company. No

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(*ii*) a declaration from an Advocate, a Chartered Accountant, or a person holding a Managerial position in the company that the requirements of the Act in regard to Registration have been duly complied with ;

(*iii*) a list of the persons who have agreed to act as Directors of the Company (this is required only for Public Companies Limited by Shares) ;

(*iv*) intimation of address of Registered Office (Notice of the situation of the Regd. Office, and of every change therein, shall be given within 28 days after the date of Incorporation of the Company or after the date of the change, as the case may be, to the Registrar who shall record the same).

Allotment of Shares will be permissible of a Company, if the minimum number of Shares required to cover the *Minimum Subscription* as mentioned in the Prospectus have not been applied for. If, for instance, Rs. 10,000 be the amount of Minimum subscription stated in the Prospectus, and if the Shares are all of Rs. 10 each, at least 1,000 shares should have been applied for to cover the minimum subscription. The amount would be so fixed that without this minimum money the Company must not proceed to business. A period of 120 days from the date of issuing the Prospectus is allowed for collecting the Minimum Subscription. In case Minimum Subscription is not raised, the moneys already obtained by the Company will be returned to the Share Applicants together with a letter of regret. A Company may choose to issue a *Statement in lieu of Prospectus* by filling in the form prescribed under the Companies Act, instead of taking the trouble of drawing up a Prospectus of its own.

Limitation of time for issue of Share Certificates. Under Sec. 113 every Company, within three months after the allotment of its Shares or Debentures, must have the Certificates of all Shares, the Debentures, and the Certificates of all Debenture Stock allotted or transferred, ready for delivery.

Restrictions on Commencement of business. According to sec. 149 where a Public Limited Company has issued a Prospectus inviting the public to subscribe for its Shares, such Company shall not commence business, or exercise any borrowing powers, unless the following conditions are fulfilled : (a) Shares have been allotted for an amount not less than the Minimum Subscription ; (b) every Director of the Company has paid in full on each of the shares taken by him the amounts as payable on Application and Allotment ; and (c) there has been filed with the Registrar of Companies a duly verified declaration by one of the Directors or the Secretary in the prescribed form that the above conditions have been fulfilled.

Annual Return. Under sec. 159, every Company having a Share Capital shall, within 42 days from the date of the Annual General Meeting, prepare and file with the Registrar

of Companies a Return called the *Annual Return* containing the following particulars :—

(a) Address of the Company's Registered Office.

(b) The names and other particulars of the shareholders, past and present, as per Members' Register.

(c) The names and other particulars of the Debenture holders, past and present, as per Debentureholders' Register.

(d) An account of the Shares and Debentures issued by the Company.

(e) Nature of the Company's indebtedness to different parties.

(f) Names and other particulars of Directors, Managing Directors, Managing Agents, Secretaries & Treasurers and Managers, past and present.

Annual General Meeting. According to sec. 166 every company shall hold its Annual General Meeting in the following manner :—

(a) The first Annual General Meeting will be held within 18 months of the Company's incorporation.

(b) The next and subsequent Annual General Meetings will be held within six months after the expiry of the financial year* chosen by the Company.

(c) The interval between the date of one Annual General Meeting and that of the next should not be one of more than 15 months.

(d) The meeting is to be called by sending not less than 21 days' Notice in writing (a shorter Notice may

be allowed if there is consent of 95 to 100 per cent. of the Members entitled to vote) and the Directors' Report accompanied by the Audited Accounts to every member and to the Registrar of companies.

(e) The Meeting will usually transact the following pieces of business : (i) adopting the Directors' Report together with the Annual Accounts ; (ii) electing Directors and appointing the Auditor ; (iii) making Appropriations of profits and declaring Dividends, if any ; and (iv) doing any other business of ordinary importance.

(g) According to sec. 168, if default is made in holding the Annual General Meeting in any year in time, the Company, and every Officer of the Company who is in default, shall be punishable with fine as prescribed by law.

Resolutions. Sections 188-192 deal with the question of *Resolutions* to be passed at the meetings of a Company. A resolution means a proposal, put before a meeting in the form of 'Motion', duly carried. There may be three types of Resolutions : (i) Ordinary Resolution, (ii) Special Resolution and (iii) Resolution requiring Special Notice. An *Ordinary Resolution*, to be passed by a simple majority vote, will be required for matters of ordinary importance, such as passing the Annual Accounts, declaring Dividends, electing Directors, etc. A *Special Resolution* will be necessary for matters like amending the Memorandum and the Articles, making the Company voluntarily wound up, reducing the Share Capital, etc. Under Sec. 189, the following are the requirements for a Special Resolution :

(a) in the Notice for General Meetings, it should be mentioned that the Company intends to propose a certain resolution as 'Special Resolution' ; and

(b) the resolution has to be passed at the Company meeting by three-fourth majority vote.

The cases for 'Resolution requiring Special Notice' are : the removal of a Director, the appointment of a Director who

has crossed the age limit 65, the appointment of an Auditor other than the retiring Auditor, etc. Special Notice is to be served on the Company at least 14 days before the Meeting and the Company should give to its Members notice of such resolution forthwith.

Managerial Remuneration. According to sec. 198, in the case of a Public Limited Company or a Private Company which is Subsidiary of a Public Company, the total remuneration payable to the Directors together with the Managing Director (or the Managing Agent or the Secretaries and Treasurers or the Manager) shall not exceed 11% of the Net Profits of the Company. The fees payable to Directors are not to be included in this eleven per cent., but charged against the Gross Profits. The perquisites (i.e, the casual emoluments sanctioned for somebody in Management over and above his normal remuneration) payable to persons at Management level will be calculated as part of Managerial Remuneration. The Net Profits, for the determination of Managerial Remuneration, must be computed in accordance with sections 349, 350 and 351 discussed later, and after due provision for Depreciation as per the requirements of sec. 205. According to sec. 199, where any commission or other remuneration payable to any officer of a Company is fixed at a percentage of the Net Profits, such profits shall also be calculated on the basis of the sections quoted above According to sec. 200, no Company shall pay to any officer or employee of the concern any tax-free remuneration. Where the profits are nil or insufficient a Company may pay to the Directors and other Managerial staff, if any, by way of minimum remuneration, a sum not exceeding Rs. 50,000 per annum subject to the sanction of the Articles.

Manner and time of Dividend payment. A Company, subject to sanction of the Articles, may pay dividends, only in proportion to the amount paid upon each share. Sections 205-207 deal with the question of Dividend payment. The regulations are that there would be no declaration or payment of Dividend except out of the Profits of the Company. And the Profits would be arrived at after due provision for Depreciation. Even where

profits are nil or inadequate, Dividend payment can be arranged if moneys are provided, by the Central or a State Government, for the payment of the Dividend, in pursuance of a guarantee given by such Government. Dividend shall be paid only to Registered shareholders or to their authorised persons or to their Bankers ; where a Share Warrant (discussed earlier under 'Share Capital Audit') has been issued, Dividend may be paid to the bearer of such warrant or to his Bankers. In the absence of there being valid reasons as stated in the Act for Dividend payment being withheld, those in the Management will be liable to punishment if there is failure to distribute Dividends within 42 days of the Dividend declaration. Before Dividends would be paid, taxes must be deducted at source.

Accounts of a Company. Sections 209-223 deal with Books of Accounts to be kept by a Company and regulations pertaining to Annual Accounts and Balance Sheet. It has been prescribed that proper Books of Accounts, recording (i) details of moneys received and spent, (ii) particulars of all sales and purchases, and (iii) the Assets and Liabilities of the Company, shall be duly maintained. Every Balance Sheet of a Company shall give a true and fair view of the state of affairs of the Company as at the end of the Financial year and shall be drawn up in the Statutory form as shown in the form of appendage to this book. Every Profit and Loss Account (or Income & Expenditure Account) of a Company shall reveal the true trading results for the financial year in the form prescribed under the Companies Act. In the Final Accounts there should be columns for figures for the previous year so that the trading position of the current year may be compared with that of the previous year. The Company Balance Sheet will show the Assets and Liabilities under proper Headings in order that anybody casting a glance over the Balance Sheet may quickly have an idea about the exact trading position of the concern. The Balance Sheet of a Holding Company will be published with the following particulars of its subsidiaries :—

(a) a copy of the Balance Sheet of the Subsidiary ;
(b) a copy of its Profit & Loss Account ;
(c) a copy of the Report of its Board of Directors ;

(d) a copy of the Report of its Auditor ;
(e) a Statement of the Holding Company's interests in the Subsidiary ;
(f) a Statement of changes introduced to the Subsidiary's Fixed Assets and Investments and money lent or borrowed not for meeting current liabilities (this statement will be required, only where the Financial Year of the Subsidiary Company is not the same as that of the Holding Company).

Under proper groupings will appear the Assets and Liabilities where Accounts are compiled in a consolidated form. The Auditor is to pay particular care and attention to transactions between the *Parent* Company and its subsidiaries. Inter-Company investments and one's indebtedness to another ought to come under his special scrutiny.

In all cases the Profit & Loss Account shall be annexed to the Balance Sheet and the Auditor's Report must accompany that. To every Balance Sheet, laid before a Company in General Meeting, will be attached a report by its Board of Directors embracing the following matters : (i) the state of the Company's affairs, (ii) the amounts, if any, proposed to be carried to any Reserves and (iii) the amount recommended for Dividend payment. There shall be filed with the Registrar of Companies three duly signed copies of the Balance Sheet and the Profit & Loss Account together with three copies of all Documents which are required under the Companies Act to be annexed or attached to such Balance Sheet or Profit and Loss Account. For a Banking Company, according to the form as given in the Banking Companies Act 1949 and for an Insurance Company, in keeping with the form shown in the Insurance Act 1938, the Balance Sheet and Profit & Loss Account of these companies are to be prepared.

Audit. Sections 224-233A deal with the question of Audit and the Auditors, and this portion of the Companies Act has been given as Appendix to this Book. The contents of these sections have earlier been discussed in the chapter entitled 'The Auditor of a Limitd Company' (Chapter XII).

Branch Accounts. Section 228 deserves particular mention. Under this section, where a Company has Branch Office, the Accounts of that Office shall be audited by the Company's Auditor according to sec. 224 or by a person qualified for appointment as Auditor of the Company under sec. 226, that is, by a Chartered Accountant of India, holding a Licence of Practice. If the Branch Office is outside India, the Accounts shall be audited by a qualified Auditor of that place.

Employees' Securities and Provident Funds. According to sec. 417, all moneys or Securities deposited with a Company by its Employees in accordance with their Service Contracts shall be kept in a Post Office Saving Bank Account or in a Special Account to be opened by the Company in a Scheduled Bank or State Bank and shall not be utilised by the Company. Under sec. 418, where a Provident Fund has been constituted by a Company for its Employees, all moneys contributed to such Fund by the Employees and the Company, or accruing by way of Interest to such Fund, shall be either deposited in a Post Office Savings Bank Account or in a Special Account to be opened by the Company in a Scheduled Bank or State Bank or invested in Securities *approved* by the Government.

Foreign Companies. Under Sec. 594, every foreign Company doing business in India must make out a Balance Sheet and Profit and Loss Account in the same manner as prescribed under the Companies Act and deliver three copies of those Documents to the Registrar. Under sec. 595, the Prospectus of such Companies inviting subscriptions in India for their Shares or Debentures must state the country in which the Company is incorporated.

Application of the Companies Act to Companies governed by Special Acts. According to sec. 616, the provisions of the Companies Act shall apply :

(a) to Insurance Companies if they do not run contrary to the provisions of the Insurance Act 1938 ;

(b) to Banking Companies if they are not inconsistent with the provisions of the Banking Companies Act 1949 ;

(c) to the Electricity Companies if they are not inconsistent *with the provisions of the Electricity* Supply Act *1948 ; and*

(d) to any other Statutory Company if they are not inconsistent with the provisions of the Special Act under which the Company is formed.

Government Company. According to sec. 617, where 51% or more of the Paid-up Share Capital of a Company are held by the Central Government or any of the State Governments, such Company shall be known as Government Company. According to sec. 618, a Government Company has no permission for appointing any Managing Agent. All the Subsidiaries of a Government Company are also to be regarded as Government Companies. According to sec. 619, the Auditor of a Government Company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor-General of India who will direct the manner and programme of Audit. The Auditors shall submit a copy of the Report to the Comptroller and Auditor-General of India who shall have the right to comment on the Audit Report. This Audit Report along with the comments made on it will be placed before the Annual General Meeting of the Government Company.

SECTIONS ON COMPANY MANAGEMENT

Different Managerial Persons. Sections 252-388 deal with the question of the management of a Joint Stock Company. Every Public Company, and every Private Company which is a Subsidiary of a Public Company, shall have at least three Directors. Other Private Companies shall appoint at least two Directors. Apart from the Board of Directors (often referred to as 'Board') a company may choose to appoint any one of the following to attend the day-to-day administration of the Company's business :—

(a) Managing Director or Wholetime Director
(b) Managing Agent
(c) Secretaries & Treasurers
(d) Manager.

A Director and the Manager must always be individuals. The Managing Agent may be an individual, a firm, or a Limited Company. The Secretaries and Treasurers will always be either a firm or a body corporate.

Provisions relating to Directors. Subject to the contents of the Articles, the Subscribers (or signatories) to the Memorandum will act as the first Directors of the Company. Subsequent Directors will be appointed at the Company Annual General Meeting. The Managing Agent of a Company may nominate two of the Directors of the Company where the total number of Directors exceeds 5 and where the total number of Directors is 5 or less than 5, one Director may be nominated by the Managing Agent. For a Public Company having a Share Capital it is required that every Director will sign and file with the Registrar a consent in writing to act as Director and will take, or will enter into a contract to take, Qualification Shares, if any, as fixed by the Articles. The Share qualification is to be acquired within two months of appointment as Director. The Nominal Value of the Qualification Shares shall not exceed Rs. 5,000/-. Where the Nominal Value of a Share is more than Rs. 5,000/-, Qualification Share shall be one in number. For the election of Directors, there must be a separate Resolution for each Director. Persons other than a retiring Director will be eligible for election if 14 days' notice has been duly given. No person who has attained the age of 65 can continue as Director unless approved by the shareholders of the Company by a Resolution, of which Special Notice has been given. Not more than two months may pass between the last day of the month in which a Board Meeting is held and the date of the next meeting. A Director must pay the call money on the Shares held by him within six months of call and without the consent of the Board must not absent himself from three consecutive Board Meetings or be absent for three months, whichever is longer. It is within the powers of the Board to make allotment of and calls on the Shares, to issue Debentures and borrow money, to invest surplus funds of the company suitably and to look after other matters of internal management. In the case of Public Companies and their Subsidiaries two-thirds of the total number of Directors must retire by rotation under sec. 255. If the Directors were

appointed on the same date they should retire by lot. Under sec. 274, a person of unsound mind, an undischarged insolvent or a person convicted of any offence involving moral turpitude, or one that has not made payment of call money on Shares held even after six months from the date of call, cannot be appointed a Director. Under sec. 275, a person cannot be the Director of more than 20 Companies at a time. By Ordinary Resolution passed after the serving of Special Notice, a Director of a Company may be removed from his office, before the expiry of his term. Under sec. 291, the Board of Directors will be entitled to exercise all the powers of the Company other than those to be exercised at the shareholders' meeting. Under sec. 293 the Board of Directors have no power to do the following without the consent of shareholders at the General Meeting : sell, lease or dispose of the whole or the major portion of the Assets of the Company ; give time for repayment of a debt due by a Director ; borrow in excess of the Paid-up Capital of the Company and the free Reserves ; invest sale proceeds of any property of the company otherwise than in Trust Securities ; appoint sole Selling Agents (in no case for more than 5 years at a time) ; or contribute to charitable or welfare fund an amount exceeding Rs. 25,000 or 5% of last three years' average Net profits, whichever is greater. Under sec. 295, without the consent of the Central Government, no company may grant any loan to or give any guarantee or provide any security in connection with a loan to the following :—(a) any Director of the Lending Company, (b) any Director of its Holding Company where the Lending Company is a Subsidiary, (c) any relative or partner of the Director of the Lending Company, (d) any firm in which such Director or his relative is a partner, (e) any Private Company in which the Director of the Lending Company is also a Director or a Member, (f) any Company 15 per cent. or more of whose voting power is controlled by the Director of the Lending Company, (g) any Company whose Board of Directors act in accordance with instructions from the Lending Company's Directors. The restrictions regarding making loans will not apply for a Private Company, a Banking Company or where a Holding Company lends to its Subsidiary or where the Managing Agent, or the Secretaries and Treasurers will lend to a Company

under their Management. Loans if grantd to any Director of the Company under consent of the Central Government should be shown separately under 'Loans and Advances' on the face of the Balance Sheet. Under sec. 297, except with the consent of the Board of Directors, a Director of the Company shall not enter into any contract with the company for the sale, purchase or supply of any goods, materials or services or for underwriting the company's Shares or Debentures. Disclosure of any interest in any contract by a Director must be made at the first Board Meeting after the Director becomes interested. The above restriction does not apply to Private Companies. Under sec. 314, except with the previous consent of the Company obtained by a Special Resolution no place or office of Profit shall be held by a Director or by a firm or company in which such a Director is interested.

Under sec. 309, the remuneration payable to the Directors of the Company shall be as follows subject to the provisions of the Articles :—

(i) If there are any Managing or wholetime Directors not more than 5% of the net profits for each such Director subject to a maximum of 10% for all (no commission or remuneration to be received from any Subsidiary of the Company).

(ii) Where there is any wholetime or Mg. Director, the other Directors will be receiving not more than one per cent. of the Company's net profits and in the absence of there being any Mg. or wholetime Director, the other Directors are to receive by way of remuneration a sum not exceeding 3% of such profits.

(iii) A Director who is either in the whole-time employment of the Company or is a Managing Director may be paid remuneration either by way of a monthly payment or at a specified percentage of the Net Profits of the Company or partly by one way and partly by the other. It must, however, be seen that the total payment of remuneration does not exceed *five per cent.* of the Net Profits for one such Director. The limit may be exceeded under special sanction from the Central Government.

Provisions relating to 'Managing Director'. The Directors of a Company usually have no time or capacity to give wholetime service and as such, they, in many cases, choose a Managing or wholetime Director. No Company shall appoint any person as Managing Director if he is either the Managing Director or Manager of any other Company unless a unanimous Resolution has been passed for such appointment at the Board Meeting. This provision shall apply only for Public Companies and their Subsidiaries. Under sec. 317, no Company shall appoint any individual as its Mg. Director for a term exceeding 5 years at a time. Payments may be made by a Company, under sec. 318 to its Mg. or wholetime Director or a Director holding the office of Management, by way of compensation for loss of office or retirement from office.

Provisions relating to 'Managing Agent'. Under sec. 324, the Central Government may, by notification, declare that some classes of industry or business shall not appoint any Mg. Agent after August 15, 1960. According to sec 325, a Managing Agency Company will not be allowed to appoint a Mg. Agent for its own administration. For example, if ABC & Co. Ltd. is the Managing Agent of another Limited Company, there cannot be any appointment of a Managing Agent for conducting the management of ABC & Co. Ltd. Under the same section, a Company which is the Subsidiary of a body corporate cannot be chosen for appointment as Managing Agent of any Limited Company. Under sec. 10 of the Banking Companies Act 1949, no Banking Company shall employ or be managed by a Managing Agent. According to sec. 326, Appointment or Re-appointment of a Mg. Agent can only be made by the Company in General Meeting, subject to the approval of the Central Government. Under sec. 328, a Mg. Agent cannot be appointed for the first time for a period exceeding 15 years. Subsequent appointments should be made for a period not exceeding 10 years at a time. Re-appointment or appointment of a Mg. Agent for a fresh term will be irregular when the present Mg. Agency agreement has yet two years or more to run. Under section 329, the terms of a Mg. Agency agreement may be changed by an ordinary resolution of the shareholders, subject to the sanction of the Central Government. According

to sec. 350, term of office of existing Mg. Agents will terminate on 15th August, 1960 unless before that there is reappointment for a fresh term, under approval from the Central Government. Under sec. 332, no Mg. Agency House may be the Mg. Agent of more than 10 Companies at a time. In calculating the number of companies to be under the same Mg. Agent the following should be excluded : (a) a private company, not being a Subsidiary or a Holding company of a public company ; (b) a company with *unlimited liability ;* and (c) a non-profit-earning company. Under sec. 334, the Mg. Agent of a Company will vacate office on the happening of the following events :—if an individual, on being adjudged an insolvent ; if a firm, on its Dissolution ; and if a Company on its winding up. Under sec. 335, if a Receiver is appointed by the Court for the property of the Mg. Agent, the Mg. Agent will be considered to have been suspended from his office. Under sec. 337 a Company may, by Ordinary Resolution of Shareholders, remove its Mg. Agent for fraud or breach of trust and under sec. 338, a Company in General Meeting may by Special Resolution, remove its Mg. Agent for gross mismanagement or gross negligence. Under sec. 343, a transfer of his Office by the Managing Agent or any arrangement of that kind will be void, if there is no sanction both from the Company in General Meeting and from the Central Government. According to sec. 346 (1), approval from the Central Government has to be taken whenever any change takes place in the constitution of the Managing Agency firm or corporation. Under sec. 348, a Company cannot pay, to its Mg. Agent by way of remuneration, any sum of money in excess of 10% of the Net Profits of the Company for any financial year. Sections 349 and 350 relate to the determination of Net Profits for the purposes of Managerial Remuneration. For the computation of the Net Profits, profits or losses of Capital nature shall not be taken into account and the following items shall not be deducted from the Gross Profit :

(i) Remuneration payable to Directors and the Mg. Agent ;

(ii) Income Tax, Super Tax and other taxes on Income ;

(iii) Damages of any kind other than for Breach of Contract.

The following will be allowed to be deducted from the Gross Profit:—

(a) Working Charges

(b) Bonus or Commission to staff

(c) Interest on Debentures, Mortgages, Charges, Loans and Advances

(d) Repairs not of Capital nature

(e) Normal Depreciation and not initial or additional Depreciation

(f) Trading Losses arising after the commencement of the Companies Act 1956

(g) Debts considered bad and written off

(h) Contributions to political parties

(i) Extra and Shift Allowances paid to labour.

Under sec. 352, additional remuneration beyond 10% of the Net Profits may be paid to the Mg. Agent, if sanctioned by the Company by Special Resolution and approved by the Central Government in the public interest.* Under sec. 354, a Mg. Agent is not entitled to any Office Allowance but to him the Company must pay back any actual expenditure incurred on behalf of the Company provided the same is sanctioned by the Board and by the Shareholders' Meeting. Sections relating to Mg. Agent's Remuneration do not apply to Private Companies that are not subsidiaries of Public Companies. Under sec. 356,

* Subject to the maximum limits permissible under the Act. the following sliding scales of Commission on Net Profits, as notified by the Government of India, will apply :—

	Managing Agents	Secretaries & Treasurers
On the 1st Rs. 10 lakhs or fraction thereof ..	10 %	7½%
„ 2nd Rs. 10 lakhs „ ..	9 %	6¾%
„ 3rd Rs. 10 lakhs „ ..	8 %	6 %
„ 4th Rs. 10 lakhs „ ..	7 %	5¼%
„ 5th Rs. 10 lakhs „ ..	6 %	4½%
„ next Rs. 25 lakhs or fraction thereof ..	5½%	4⅛%
„ „ Rs. 25 lakhs „ ..	5 %	3¾%
On any sum over Rs. 1 crore	4 %	3 %

a Mg. Agent or his Associate cannot be appointed as Selling Agent for the Company's goods within India. For places outside India, however, there will be no bar in this respect, provided the Mg. Agent has already a place of business there. The remuneration for such appointment is to be sanctioned by the Company by Special Resolution and the appointment can only be for 5 years at a time. Under sec. 358, a Managing Agent or his Associate should not receive any payment as Buying Agent in respect of the purchases made by the Company in India. But purchases made outside India may be paid for, provided the Mg. Agent has got an office for its own purpose at the place of purchase. Such payment must be sanctioned by a Special Resolution and the appointment can be made only for 3 years at a time. Under sec. 360, a Managing Agent or his Associate may enter into a contract with the managed Company, for the sale, purchase or supply of any property or for the rendering of any service with consent of the Company by Special Resolution and approval of the Central Government. Contracts up to Rs. 5,000 in respect of property or services, in which the Company or the Managing Agent regularly trades are exempted. Under sec. 369, no Public Company or its subsidiary shall make any Loan or give any Guarantee or provide any Security in connection with the Loan to its Managing Agent or to the Associates of the Managing Agent. Nothing contained in this section shall apply to any Credit given by the Company to its Managing Agent for the purpose of facilitating the Company's business. Sec. 370 deals with Loans to Companies under the same management. No Company shall make any Loan to, or give any Guarantee or provide any Security to, another Company under the same Management unless sanctioned by Special Resolution of the lending Company. Section 372 deals with *Inter-Company Investments*. A Company may invest moneys up to a specified limit in the Shares of another Company under the same management on the strength of unanimous Board Meeting Resolution. When such an investment goes beyond the allowable limit, Central Government's sanction and approval of the Shareholders' Meeting will be required. The allowable limit of Inter-Company Investment referred to above will be as follows: not more than 10% of the Subscribed Capital of

the Company in whose Shares the investment is made, but the total of investments in all the Companies in the same group should not exceed 20% of the Subscribed Capital of the investing company. This section further provides that the aggregate of the investments made in all other Companies *within the same group* and outside the group should not exceed *30% of the Subscribed Capital of the investing Company.* Such investments should be entered in a separate Register with details and every Company must annex to its Balance Sheet at each year end a list of such Investments with details. The above restrictions do not apply to the following ; (i) a Banking Company, (ii) an Insurance Company, (iii) a Private Company which is not a subsidiary to a Public Company, (iv) Holding Company making investments in its subsidiaries and (v) a Managing Agent making investments in a Company under his management. Under sec. 375, the Managing Agent of a Company shall not engage on his own account in any business competing with the business of the managed Company, unless sanctioned by Special Resolution passed in General Meeting. The Auditor of the Company would do well to examine the terms of Managing Agency agreement thoroughly and carefully.

Provisions relating to 'Secretaries and Treasurers'. According to sec 378, a Company may appoint a firm or a body corporate as its Secretaries and Treasurers provided it has no 'Mg. Agent' or 'Mg. Director' or 'Manager'. The provisions of the Companies Act relating to Managing Agent will all apply in the case of Secretaries and Treasurers excepting the following :—

(i) Central Government, unlike the case of Managing Agent, will have no power to ban the appointment of Secretaries and Treasurers in any specified class of industry or business (sec. 380).

(ii) Maximum Remuneration allowable for Secretaries and Treasurers is $7\frac{1}{2}\%$ of the Net Profit of the Company to be calculated as under sections 349-351 (sec. 381).

(iii) Regulations pertaining to termination of office of the Managing Agents functioning before 15th August

1960 and the law relating to maximum number of Companies (10) under the same Managing Agent will not apply for Secretaries and Treasurers (sec. 380).

(iv) The Secretaries and Treasurers cannot appoint any Director for the Company under management, as the Managing Agent can do (sec. 382).

(v) Without the sanction of the Board of Directors, the Secretaries and Treasurers will have no authority to sell goods or services produced by the Company under management or to purchase or acquire goods, materials, stores or machinery for its purpose (sec. 383).

Provisions relating to the 'Manager' of a Company. Sections 384-388 deal with *Manager* to be appointed by a Company when there is no Managing Agent or Managing Director or Secretaries and Treasurers. Under sections 384 and 385, a firm, or a body corporate, or an undischarged insolvent, or a person having suspended payment to his creditor, or a person convicted by a court in India of moral turpitude, cannot be appointed 'Manager' of a Company. Under sec. 386, a Company with the unanimous approval of the Board of Directors, may appoint a person as its Manager, if he is the Manager or Managing Director of not more than one other Company. If X is already the Manager or Managing Director of PQR Co. Ltd. and if now he has been proposed to be appointed the Manager of ABC Co., Ltd. all the Directors of ABC Co., Ltd. must agree to this appointment. Under sec. 387, the remuneration payable to the Manager of a Company cannot be more than 5% of the Net Profits of the Company to be calculated on the same basis as in the case of Managing Agents. For any payment beyond this limit, approval of the Central Government must be obtained. According to sec. 388, as in the case of a Managing Director, a Manager also cannot be in office for more than 5 years at a time. Rules regarding increase in remuneration and prohibition of assignment of Office are the same for the Manager and the Managing Director.

QUESTIONS ON CHAPTER XIII

1. *The Directors of a Limited Company governed by Table A proposed to the General Meeting a dividend at the rate of 7½ per cent. per annum.*

The shareholders, being dissatisfied, carried an amendment, declaring a dividend at the rate of 10 per cent. per annum, and this was duly paid.

If you are subsequently auditing the Accounts of this company, what should be your attitude ? (M. Com.)

[*Hints* : As regards the payment of dividend, the decision of the shareholders at the Annual General Meeting is final. The Directors can only recommend the payment of a dividend, but it must be passed by a Resolution of shareholders at the Annual General Meeting. In this case, however, the Auditor would point out the irregularity in dividend declaration so far as the rate is concerned. He should draw the attention of the Directors to clause 85 of Table A which reads as follows : *The Company in General Meeting may declare dividends, but no dividends shall exceed the amount recommended by the Board.*]

2. What legal documents of a company should an Auditor examine prior to the commencement of the first Audit and to what points should his special attention be directed in the examination ?

[*Hints* : The Auditor will examine the undernoted legal documents :—

(a) The Memorandum of Association and the Articles of Association of the Company (sections 12, 13, 14, 26, 29).

(b) The Prospectus of the company (sections 55-60) (for Public Limited Companies only).

(c) The Contracts (sec. 46).

(d) Sanction from the Controller of Capital Issues, Central Government, where necessary, regarding Authorised Capital.

(e) Register of Investments held in company's own name (sec. 49).

(f) Register of Charges and Copy of the Deed creating the Charges (sections 136 and 143).

(g) Register and Index of Members (sections 150, 151 and 163).

(h) Register and Index of Debenture holders (sections 152 and 163).

(i) Minute Books of Board Meetings and Shareholders' Meetings (sec. 193).

(j) Books of Accounts (sec. 209).

(k) Register of Contracts, Companies and Firms in which the Directors of the company are interested (sec. 301).

(l) Register of Directors, Managing Agents, Secretaries and Treasurers, etc. (sec. 303)

(m) Register of Directors' shareholdings (sec 307).

(n) Register of Contracts with Managing Agents, Secretaries and Treasurers, etc. (sections 356, 360 and 379).

(o) Register of Inter-company Loans (sec 370)

(p) Register of Shares, etc, of other companies (sec. 372).

(q) Certified Copy of the Resolution passed at the Board Meeting or at the Shareholders' Meeting, as required by law, in connexion with the Auditor's appointment.

In examining the above documents, the Auditor should direct his special attention to the following points :—

(a) The Object and the Capital clauses in the Memorandum. In the Articles—the Classes of Shares and their Rights ; Application, Allotment and Calls of Shares , Forfeiture and Re-issue of Shares ; Underwriting Commission and Brokerage on the subscription of Shares ; Borrowing Power , Alteration of Capital ; Powers, Duties, Qualifications and Remuneration of Directors and their number ; Powers, Duties and Remuneration of Managing or Wholetime Directors, if any ; Powers, Duties and Remuneration of Managing Agents ; Regulations as to Directors' Meetings and Shareholders' Meetings ; Provisions regarding Accounts, Audit, Dividends, Reserves, etc.

(b) The main Objects of the company with Names, Descriptions, Addresses and Occupations of the Signatories to the Memorandum of Association and the Articles of Association ; the Number and Classes of Shares ; Qualification Shares of Directors ; Remuneration of Directors ; Names,

Addresses and Occupations of Directors, Managing Director, Managing Agents, Secretaries and Treasurers and the Contracts entered into with them ; the extent of Preliminary Expenses ; Amounts payable on Application, Allotment and Calls ; and Minimum Subscription. In case of a business purchase of a going concern, the Auditors' Report regarding the Profits and Losses of the Vendors for the preceding five years, dividends paid, statement of Assets and Liabilities of the Vendors on or about the date of transference of Ownership and the mode of settlement of Purchase Consideration.

(c) Terms of Contracts with Underwriters, Vendors, Managing Agents, Secretaries and Treasurers, etc.

(d) The letter containing necessary sanction regarding the amount of Share Capital.

(e) The value and other particulars of the Investments held by the company.

(f) Details of the property mortgaged and the names of parties entitled to the Charge.

(g) Details of Members' holdings with distinctive Share No.

(h) Particulars of Debenture holders and their holdings.

(i) The Resolutions, particularly on the appointment of Directors, Auditors and Bankers, approval of Allotments and Calls, adoption of Final Accounts and declaration of dividends.

(j) The Books of Accounts opened by the company and the nature of record therein.

(k) To what extent the Directors are interested and the nature of the interest.

(l) Details of the names, addresses and the business acumen of the persons in 'company management'.

(m) Number of Shares and the amount paid on such Shares.

(n) How appointed. Terms and conditions ; power and duties ; remuneration.

(o) Names of companies under the same management and the amount of loans.

(p) Details of the Shares bought, particularly the face value, the cost price and the market price.

(q) Verifying the authenticity of the Resolution on Appointment by reference to Directors' Minute Book or Shareholders' Minute Book, as the case may be.]

3. How do you suggest a profit on redemption of Debentures to be treated when no Sinking Fund has been created ?

(B. Com.)

[*Hints* : Such profit is of Capital nature, and may be utilised in writing off losses in connexion with Debentures, or may be transferred to Capital Reserve.]

4. A Limited Liability Manufacturing Company has made considerable additions to its workshop buildings. Sufficient cash not being available, additional funds required have been borrowed from the company's Bankers, and interest has been paid on the loan. The Directors desire that the amount of interest paid during the period of construction should be charged to the Building Account, as it was an expense not incurred in the ordinary course of business. (B. Com.)

[*Hints* . Interest paid on Loan from Bankers cannot be capitalised, and should be charged to Profit and Loss Account. Section 208 of the Companies Act 1956 allows, during the period of construction of Works and Buildings, payment of interest on so much of that Capital as is actually paid-up and *not* on Loan.]

5. (*a*) The Directors of a Limited Company have refused to produce before you the Minute Book. To what extent is Audit likely to be affected by such a refusal ?

(b) How will you vouch the following ?—
(i) Directors' fees and Directors' travelling expenses.
(ii) Shares issued at a discount.

(c) Briefly narrate the rights and duties of an Auditor under the Indian Companies Act, 1956.

(B. Com.)

[*Hints* : (a) The Auditor will not be in a position to know whether adequate Resolutions were passed at the Board Meeting for the adoption of Final Accounts and the amount of Proposed Dividend. Besides, he will be quite in the dark regarding matters like Allotment, Calls, Forfeiture and Re-issue of Shares, Appointment of Directors and Auditors, etc.

(b) (i) By reference to the Articles, the Directors' Minute Book and the Directors' Receipts, Travelling Expenses incurred for business purposes by a member of the Board will be vouched. The Directors' fees for attending Meetings will be vouched by reference to the relevant provisions in the Articles and the Directors' Receipts.

(ii) Shares issued at a discount should be vouched with the sanction from the Court, with Shareholders' Resolution passed at the Annual General Meeting and with Provisions of the Articles of Association. It must further be seen that each class of Shares was issued previously and that the rate of discount does not exceed 10% of the face value of the Shares. Issue of Shares at a discount can only be made at least one year after the commencement of business of the company, and such issue must be completed within two months from the date of the Court's Order.

(c) Under sec. 227 of the Companies Act, every Auditor of a company shall have a right of access at all times to the Books and Accounts and Vouchers of the company and shall be entitled to obtain from the officers of the company such information and explanations as the Auditor may think necessary for the performance of his duties as Auditor. The Auditor shall make a Report to the Members of the company on the Accounts examined by him and on every Balance Sheet and Profit and Loss Account and other attached Schedules. The Auditor's Report shall state (a) whether he obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of his Audit ; (b) whether, in his opinion, proper Books of Accounts as required by law were kept by the company so far as appears from his examination of those books ; and (c) whether the company's Balance Sheet and Profit and Loss Account exhibited a true and fair view of the state of affairs of the company and whether they were drawn up in agreement with the Books of Accounts.]

6. In what circumstances may Interest be paid out of Capital to shareholders ? What are the conditions attached to

such payment and how would you satisfy yourself that the conditions have been complied with? (B. Com.)

[*Hints* : Under sec. 208 of the Companies Act, Interest may be paid out of Capital to shareholders, on so much of the Capital as is fully paid up, during the period of construction of Works and Buildings, or of installation of Plant and Machinery, which are not expected to be profitable for a long time. Payment would, however, be subject to the following conditions :—

(a) Sanction from the Central Government is obtained.

(b) There is provision in the Articles, or Special Resolution has been passed at a General Meeting of the company.

(c) Shares are fully paid up.

(d) The rate of interest does not exceed four per cent. per annum, or the rate fixed by the Central Government.

(e) The payment of such interest does not extend beyond the close of the half-year next after the half-year during which the works or the building has been actually completed, or the plant provided]

7. A Company Limited by Shares has a large amount of surplus cash in hand. The Board of Directors decide to utilise the surplus cash in purchasing some of their own Shares. They seek your instructions as to how they should proceed in the matter and what would be the effect of such purchase. (B. Com.)

[*Hints* : Company's cash cannot be utilised for the purchase of the company's Shares. This action will be contrary to the interests of the existing shareholders, because this will reduce the company's Working Capital. The surplus cash may be utilised for the purchase of Investments in Gilt-edged Securities. To buy company's Shares out of company's cash will also be contrary to law.]

8. (a) What do you understand by the term Contingent Liability?

(b) Give four examples of Contingent Liabilities.

(c) How is Contingent Liability dealt with in the Annual Accounts of a Public Limited Company? (B. Com.)

[*Hints* : (a) Contingent Liabilities are those liabilities which may occur on the happening of some event.

(b) (i) *Arrears of fixed Cumulative Dividends on Preference Shares.*

(ii) Pending law-suits or appeals for tax clearance.

(iii) Uncalled liability on Shares partly paid.

(iv) Estimated amount of Contracts remaining to be executed on Capital Account and not provided for.

(c) If any of these liabilities has a fair chance of cropping up, adequate Reserve should be provided of the same. If not, Contingent Liability items are to be shown in the Balance Sheet as a foot-note, the figures not being extended to the amount column.]

9 State briefly the provisions of the Companies Act 1956 regarding (a) Directors' Remuneration, (b) Remuneration payable to the Managing Agents, (c) Remuneration payable to the Secretaries and Treasurers (B. Com.)

[*Hints* : (a) Sections 309 -311 deal with Directors' Remuneration. Remuneration to Directors shall be paid in the following manner :--

(i) As provided in the Articles or in the Resolution of Members, subject to provisions of the Companies Act.

(ii) The Directors' Remuneration may be by way of monthly payment or on the basis of a certain percentage on the Net Profits which shall be calculated and arrived at in accordance with sections 319 351. The Remuneration for a Managing or Wholetime Director shall not exceed 5% of the Net Profits, where there is one such Director, and 10% where the number is more than one. And in the case of other Directors the maximum rate per head will be 1%, where there are Wholetime or Managing Directors, or Managing Agents, or Secretaries and Treasurers, or Manager ; and 3% in all other cases. Remuneration payable to the Directors and other Managerial body or person shall not exceed 11% of the Net Profits (vide sec. 198).

(b) Sections 318—355 deal with Managing Agent's Remuneration. The Agreement between the company and the Managing Agent will determine the Remuneration, subject to provisions of the Companies Act. The Remuneration shall not exceed 10% of the Net Profits as calculated under sections

349—351. The Managing Agent shall not be entitled to 'office allowance', but shall be entitled to be reimbursed in respect of expenses incurred on behalf of the company.

(c) Section 381 deals with the Remuneration payable to the Secretaries and Treasurers. A maximum of $7\frac{1}{2}\%$ of the Net Profits as calculated under sections 349—351 shall be paid to the Secretaries and Treasurers of a company. For sliding scales of Commission on Net Profits as prescribed by the Central Government vide "Text".

In the absence or inadequacy of profits in a particular year, an amount not exceeding Rs. 50,000 a year may be given by way of remuneration for all of the persons in 'company management'. This would be subject to sanction from the Central Government.]

10. (a) Mention six important matters to be included in the Prospectus of a Public Limited Company.

(b) What certificates, if any, from the Auditors of the company are required to be included in such a Prospectus ?

(B. Com.)

[*Hints* : (a) The following important matters must be included in the Prospectus of a Public Limited Company :—

(i) Particulars of different classes of Shares to be issued indicating the amounts payable on Application, Allotment and Calls.

(ii) Minimum Subscription to be raised.

(iii) Underwriting Commission and Brokerage.

(iv) Preliminary Expenses.

(v) Names, Addresses and Occupations of Directors, Promoters, and other important persons connected with the company, such as Bankers, Solicitors, &c.

(vi) Directors' Qualification Shares

(b) Usually, no certificate from the Auditors would be required for being included in the Prospectus when company is formed. But in the case of purchase of a going business by a company from the vendors, an Auditor's certificate will be necessary regarding Profits and Losses of the business for the last five years, and the Assets and Liabilities of the business

purchased. *This certificate will be inserted in the Prospectus. In the case of subsequent issue of* Shares by a company the Prospectus will contain a similar certificate from the Auditors of the company.]

11. What are the provisions of the Companies Act 1956 in relation to (a) Keeping of Books of Accounts ; (b) Application of Premiums received on issue of Shares ? (B. Com.)

[*Hints* : (a) Section 209 deals with the *Keeping of Books of Accounts.* Every company shall keep at its registered office proper Books of Accounts with respect to : (i) all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure take place ; (ii) all sales and purchases of goods by the company ; and (iii) all of the Assets and Liabilities of the company.

(b) Section 78 deals with the *premium* received on the issue of Shares. The amount of the 'premium' shall be transferred to Share Premium Account. This account may be utilised for the following purposes :—

(i) Issuing *Bonus Shares.*

(ii) Writing off *Discount* on the Issue of Shares or Debentures.

(iii) Writing off *Underwriting Commission,* or *Brokerage,* or Other Expenses on any Issue of Shares or Debentures.

(iv) Writing off *Preliminary Expenses.*

(v) Providing for the Premium payable on the Redemption of any Redeemable Preference Shares or of any Debentures of the company.]

12. In auditing the Accounts of a Public Limited Company you find : –

(a) That unpaid calls are shown as a deduction from the Issued Capital but it is known that such unpaid calls are irrecoverable.

(b) That the market value of the Investments is lower than the cost price at which they appear in the Balance Sheet.

(c) That there is a suit pending before a Court in respect of goods supplied by a creditor.

In your opinion what steps should be taken by the company to deal with the above? (B. Com.)

[*Hints* : (a) Unpaid calls (also known as calls-in-arrear) must not be shown as a deduction from the 'Issued Capital' but should be shown as a deduction from the 'Subscribed Capital', pending forfeiture of the Shares. Where the unpaid calls have definitely been irrecoverable, it should be the duty of the Directors to see that the Shares, on which the calls are unpaid, are duly forfeited in accordance with the provisions in the Articles. There is no implied power in the Act to forfeit Shares for non-payment of calls, but the Articles usually contain necessary power of forfeiture. In the absence of any Articles, such Shares are to be forfeited according to the provisions of Table A, after serving proper Notice to the defaulting shareholder.

(b) If the market value is much lower than the cost price, the desirability of creating an Investment Reserve, by appropriation of the profits, may be pointed out. Alternatively, a *note* should be given on the Balance Sheet against Investments, mentioning the current market value.

(c) Liability on account of the goods supplied should be included in the Accounts together with the legal cost.]

13 A company receives deposits from shareholders and others as help towards the Working Capital. The company has also lent some money to a rival company having some common Directors on the two Boards. In the Balance Sheet of the lending company, the amount of the "Deposits from Shareholders and others" was shown after deducting the amount lent to the rival company. Comment on the propriety and legality of the figure appearing in the Balance Sheet, and give reference to a decided case in point.

[*Hints* : To show "Deposits from Shareholders and others" at the reduced figures, i.e., after deduction of the loan given to the rival company is a serious misdescription on the Balance Sheet. This is a wrong showing of the state of affairs of the company, and is unlawful and against the canons of propriety.

In the case of Superintendent and Remembrancer of Legal Affairs, Bengal *v.* Akhil Bandhu Guha and others, there was a misdescription of the above nature

on the Balance Sheet of a Cotton Mill Company. It was held that a 'Loan' and a 'Deposit' were items completely different from each other, and the consolidation of the two into one item in the Balance Sheet would mean suppression of material particulars. The Managing Directors were found guilty and sentenced to imprisonment and fine.]

14. State the particulars which are required to be disclosed in the Balance Sheet by the Companies Act in regard to :—

(i) Share Capital.

(ii) Fixed Assets.

(Chartered Accountants)

[*Hints* : (i) 'Share Capital' is to be shown in the Balance Sheet, the distinction between the *various classes of Capital being clearly exhibited.* The extent of the Authorised Capital, the Issued Capital and the Subscribed Capital must be clear on the face of the Balance Sheet. From each class of Capital, unpaid calls would be shown as a deduction. The *details of calls unpaid* should be given as follows :

(a) due by Managing Agent or Secretaries and Treasurers ;

(b) due by Directors ; and

(c) due by others.

The following are to be shown separately and distinctly :

(a) Shares allotted as fully paid up pursuant to a Contract without payments being received in Cash ; and

(b) Shares allotted as fully paid up by way of Bonus Shares (the *source,* i.e., Share Premium money or Capitalisation of Profits or Reserves, to be specified).

Forfeited Shares are to be shown as an addition to Subscribed Capital, so long as the Capital Profit on re-issue of forfeited Shares is not transferred to Capital Reserve.

Also to be shown are :

(a) the *terms of Redemption* or *Conversion* (if any) of any Redeemable Preference Capital, together with the earliest date of Redemption or Conversion : and

(b) the particulars of any *option* on unissued Share Capital.

(ii) 'Fixed Assets' are to be shown, distinguishing as far as possible between expenditure upon (a) Goodwill, (b) Land, (c) Buildings, (d) Leaseholds, (e) Railway sidings, (f) Plant and Machinery, (g) Furniture and Fittings, (h) Development of Property, (i) Patents, Trade Marks and Designs, (j) Live-stock, (k) Vehicles, etc. Under each head of Fixed Asset should be stated :

(a) the original cost ;

(b) the additions and deductions during the year ; and

(c) the total depreciation written off or provided up to the date of the Balance Sheet.

For other particulars please consult the form of Balance Sheet as given under Schedule VI of the Companies Act (shown in the appendix of this book)]

15 Discuss the provisions of the Companies Act 1956 in regard to appointment and remuneration of Auditors.

(Chartered Accountants)

[*Hints* Section 224 of the Companies Act 1956 dwells on appointment and remuneration of Auditors. Every company shall at each Annual General Meeting of the shareholders appoint an Auditor or Auditors to hold office from the conclusion of that meeting until the conclusion of the next Annual General Meeting, and shall, within seven days of the appointment, give intimation thereof to every Auditor or Auditors, unless it is a case of reappointing the Retiring Auditor. Every Auditor, coming to the service of the company only for the first time, shall give Notice to the Registrar of Companies within thirty days of the intimation of his appointment, in writing, stating that he has accepted, or refused to accept, the appointment.

The Central Government may appoint Auditors of Joint Stock Companies, where at an Annual General Meeting no Auditors are appointed or reappointed. The Central Government may also direct a *Special Audit* under sec. 233A, where, in the opinion of the Government, there is enough fault in the administration of the company's affairs.

The first Auditor of the company shall be appointed by the Directors within one month of the date of registration of the company. Also, the Board will appoint Auditors to fill in a casual vacancy, except when such vacancy is caused through resignation.

The remuneration of the Auditor is to be fixed by the Authority that appoints him. Any sums paid by the company in respect of the Auditors' expenses shall be deemed to be included in the expression "remuneration".]

16. Discuss the liability of an Auditor for failure to detect the omission of Liabilities in the Balance Sheet. Cite the relevant Case Law. (*Chartered Accountants*)

[*Hints* : If an Auditor is unable to detect the omission of Liabilities from the Balance Sheet, there will be misdescription in the Balance Sheet, and the Final Accounts will be showing a wrong picture. In such a case the Auditor will be liable for negligence of duty. In the case of Westminster Road Construction and Engineering Co., Ltd. the valuation of Work-in-Progress was increased and *the Liabilities were understated* with the result that dividends were paid by such an amount as the true profits did not warrant. The Auditor failed to detect this misdescription in the Balance Sheet, and he was found guilty by the Court of negligence of duty.]

17 What do you understand by a Statutory Audit ? Is it necessary to carry out Balance Sheet Audit for the purpose ? If not, draw up an Audit Programme for such an Audit.

(*Chartered Accountants*)

[*Hints* : Under sec. 165 of the Companies Act, every company limited by Shares and every company limited by Guarantee and having a Share Capital shall, within a period of not less than one month nor more than six months from the date of permission to commence business by the company, hold a General Meeting of the Members of the company, which is called the Statutory Meeting. The Board of Directors of the company shall, at least 21 days before the Meeting, forward a Report to every Member of the company. This Report is called the Statutory Report which must be signed by at least two Directors of the company, one of whom shall be a Managing Director, where there is one. The Statutory Report shall contain (i) the total number of Shares allotted, distinguishing between Shares allotted for Cash and otherwise than Cash : (ii) the amount received in respect of the Shares allotted ; (iii) an Abstract of the Receipts and Payments made up to a date within seven days of the date of the Statutory Report, and certain other particulars as mentioned under sec. 165. Statutory Audit is not a

Balance Sheet Audit. The Auditors of the company shall certify the Statutory Report as correct, in so far as the Report relates to (a) the Shares allotted by the company. (b) the Cash received in respect of such Shares, and (c) the Receipts and Payments of the company. This process of certifying the Statutory Report is known as 'Statutory Audit'. For this purpose, the Auditor will concentrate on Share Capital Audit up to allotment stage, by reference to the Articles of Association and Directors' Minute Book. He will also vouch 'Preliminary Expenses' and Underwriting Commission and Brokerage by reference to the Articles and Contracts.]

18. (a) What points would you particularly check up in respect of payments of remuneration to (i) Managing Agents, (ii) Managing Director, (iii) Manager ?

(b) Can amounts be advanced to Managing Agents (i) as Loan, (ii) on Current Account ?

(Chartered Accountants)

[*Hints*. (a) (i) The following points should be given due importance while checking up 'remuneration' paid to the Managing Agents :—

(1) The Agreement between the Company and the Managing Agents.

(2) Whether the percentage on Net Profits is within the limit of 10%, and whether the percentage is calculated in terms of sections 348—351.

(3) Whether the overall Managerial Remuneration is within the limit of 11% of the Net Profits in terms of sec 198.

(4) Provisions regarding Managing Agents and their remuneration in the Articles of Association of the Company.

(ii) The remuneration of the Managing Director will be checked up with particular stress on :—

(1) Provisions in the Articles of Association of the Company.

(2) Shareholders' Resolution fixing the remuneration.

(3) The Agreement between the Company and the Managing Director.

(4) Provisions of sec. 309. This section prescribes that the remuneration of

Managing Director or Managing Directors shall not exceed the following limits : 5% when there is one Managing Director ; 10% when the number is more than one. It must be seen that a Managing Director of the company is not Managing Director of more than one other company. The provisions of sections 198,309—311, and 349—351 must have been complied with.

(iii) In respect of the remuneration of the Manager, the following will be particularly checked up :—

(1) Provisions of the Articles of Association of the company.

(2) Provisions of sec. 387. This section lays down that the remuneration shall be payable by way of monthly payment, or by way of a specific percentage of the "net profits" of the company as calculated under sections 319—351, or partly by the one way and partly by the other, the aggregate payment not exceeding five per cent. of "net profits". Provisions of sec. 198 also must be adhered to.

(3) The Agreement between the Company and the Manager.

(b) (i) Under sec. 369 Loans cannot be given to the Managing Agents. Also, amounts cannot be advanced as Loan to any associate of the company's Managing Agents, or to any body corporate acting at the instance of the Company's Managing Agents or any of their associates. This rule is not applicable to a Private Company not being a Subsidiary to a Public Company.

(ii) Money may be advanced to the Managing Agents on 'Current Account' for the purpose of facilitating the company's business. The amount would be subject to limits previously approved by the Directors of the company, and would on no account exceed twenty thousand rupees in the aggregate.]

19. The Memorandum of Association of a company with a limited liability is the fundamental Law or Charter defining the objects and limiting the powers of the company. Explain.

(M. Com.)

[*Hints* : Under sec. 12 of the Companies Act, any seven or more persons, or in the case of a Private Company any two or more persons, by subscribing their names to the Memorandum of Association and complying with the requirements of the Act, may form a "Company". The Memorandum of Association of a limited company is the fundamental Charter of the company, because in this document, in accordance with sec. 13, the Name, the State in which the registered office of the company is to be situated, the Capital and the Objects of the Company are stated fully. The company cannot transact business beyond the stipulations of the Memorandum of Association. A single footstep beyond the limits set forth by this fundamental "Law" or "Charter" would be *ultra vires*. Where any provision of the Articles of Association is in conflict with the corresponding provision of the Memorandum of Association, that of the Memorandum will decide the point at issue.]

20. (a) What do you understand by Capitalisation of Reserves ?

(b) Discuss the advantages and disadvantages of such Capitalisation from the point of view of a company and its shareholders. (M. Com.)

[*Hints* : (a) When a part or the whole of the amount at the credit of a "Reserve" Account is utilised for the purpose of issuing Bonus Shares to the existing shareholders or for making the partly paid-up Shares as fully paid-up, the process is known as 'Capitalisation of Reserves'. Subject to sanction of the Articles, any part of the company's "Reserves" or undistributed profits may be Capitalised by virtue of a decision arrived at by a Company in General Meeting on the recommendation of the Board of Directors. A step in this direction may be taken when it would be discovered that the company has built up a "Reserve" exceeding adequacy and that the shareholders have been put to a deprivation.

(b) By 'Capitalisation of Reserves' the company is benefited, because the *accumulated profits are permanently retained* in the business. Also, the *labour would cry less for a higher wage*, because profits remaining the same, there would be a fall in the rate of the dividend, and the workmen would have a less hostile attitude to their employers whom they

would hardly brand "profiteerers". Another advantage from the point of view of the company is noticed where the accumulated profits are *merged in fixed Assets*. Such fixed Assets would now correspond with a fixed Liability (through Capitalisation of accumulated profits), and, by this, the true financial picture would be reflected by the Balance Sheet. The shareholders are also benefited, because they hold more Shares in the company without payment of Cash, and enjoy more dividends. The command over liquidity is always there, as the Bonus Shares can any time be converted into hard cash.

Capitalisation of Reserves through issue of Bonus Shares cannot be resorted to where the company does not have sufficient unissued Shares to enable this operation to be performed. In that case, the Capital of the company has first to be increased. Difficulties would also arise in the matter of allotment of fractions of Shares. The volume of profits having remained the same, there would always be a fall in the rate of dividends. And this may bring about a crash in the Share Bazaar, the good name of the company and the interests of its shareholders being thereby jeopardised.]

21. Indicate some of the principal matters in connection with which the Auditor of a limited company should refer to the Directors' Minute Book. (M. Com.)

[*Hints* : The Auditor should refer to the following :

Resolution for the appointment of the first Auditor ;
Resolution for approval of the Common Seal ;
Company's Bank Account ;
Contracts ;
Allotment and Calls ;
Forfeiture of Shares and their re-issue ;
Transfer of Shares ;
Appointment of Secretary and other Officers ;
Exercise of Borrowing Powers and Issue of Debentures ;
Adoption of Final Accounts ;
Proposed Dividends ;
Appropriation of Profits ;
Creation of 'Reserves', etc.]

22. State what you consider to be the duty of an Auditor in relation to Stock-in-Trade. (M. Com.)

[*Hints* : On the Balance Sheet date the Auditor shall obtain a certified copy of the Inventory, and he should personally verify the Closing Stock by measurement, weighing or test-counts. Although it was decided in the Kingston Cotton Mill case of England that the Auditor was not a bloodhound, and, as such, in the absence of suspicious circumstances, was not bound to verify 'Stock' by personal inspection, it was, however, decided in the McKesson & Robins case of U.S.A. that the Auditor should make a physical verification of Closing Stock on the Balance Sheet date, and the latter judgement is in accordance with what the normal Auditing practice should be. It is true that the Auditor cannot have familiarity with the various types and qualities of things included in the inventory, but for that reason he *should not absolve himself of the responsibility of Stock verification*. The Auditor should gain physical contact with the inventory, at least by observing carefully the method and manner of 'Stock-taking'. And wherever he finds the method defective, he should advance his suggestions.]

23. Explain and give two examples of each of the following : (a) Contingent Liability, (b) Capital Reserve, (c) Revenue Reserve, (d) Provisions. (M. Com.)

[*Hints* : (a) Contingent Liability is that liability which might occur on the happening of some event, for example— (i) amounts unpaid on partly paid Shares ; (ii) claims against the company not acknowledged as debts.

(b) Profits arrived at by the sale of Fixed Assets, Profits made from the forfeiture and the subsequent re-issue of the Shares and such other Profits as arise from outside the course of the company's business go to build up Capital Reserve. Such "Reserves" should not usually be given away as dividends, but should be maintained for meeting losses of capital nature.

(c) Revenue Reserve is a "Reserve" built up out of trading profits, for example—Reserve for Discounts on Debtors and Reserve for Repairs and Renewals.

(d) "Provisions" would mean the amounts provided out of appropriation of the trading profits for meeting

certain specific contingencies, for example—Provision for Taxation, Provision for Dividends, &c.]

24. Set out the procedure that should be followed by an Auditor in verifying the Investments of a limited company.

(M. Com.)

[*Hints* : The Auditor should obtain a certificate from the Secretary of the company of all the Investments. With the schedule thus obtained he should personally examine all the Investments on the date of the Balance Sheet. He should also examine the Investment Register. The Auditor would in particular insist on

(i) the Investment Schedule containing all the particulars of the Investments (e.g., the full name of the Investment, the cost price, the market price, the book value, &c.) ; and

(ii) all of the Investments being produced at the same time.

Sometimes the Investments are in the names of individuals who hold them as trustees for a body corporate. Here, the Auditor should call for the Deed of Trust. If reliance is placed upon the Banker's Certificate, the Bank being the custodian of the Investments, the Auditor will look to it that the Certificate calls the Securities encumbrance-free. Where the Auditor does not find it convenient to make personal verification, he should mention in his Report the name of the person on whose Certificate he has relied for verification purpose.]

25. What do you understand by the term "Window-Dressing" ? Is it same as fraud ? What is the liability of an Auditor ? Who is a party to Window-Dressing ? (M. Com.)

[*Hints* "Window-dressing" is an art. It is the art of making the most of one's wares or abilities. In the business world by "Window-dressing" is meant a clever manipulation of the Accounts in such a manner that, on the face of the Balance Sheet, the state of affairs of the company wears a brighter look than the real one. The Management of a company, for example, may stealthily employ the business funds outside, managing to bring money for a short period near about the Balance Sheet date and showing it as 'Cash in hand'. Such manipulation is not exactly like defalcation of

cash or of goods, but may be called falsification of Accounts culminating in fraud. In the City Equitable Fire Insurance Co., Ltd. case, extensive "Window-dressing" operations were resorted to by the Chairman of an insurance company. As "Window-dressing" is tantamount to fraud, certainly it is the duty of the Auditor to detect such frauds, and for non-detection he may have to incur liability the extent of which would depend on the facts and circumstances of a particular case. Usually a bigwig in a concern is a party to "window-dressing".]

26. State six matters to which you, as Auditor, should pay special attention on first perusing the Memorandum and the Articles of Association of a limited company.

(Chartered Accountants)

[*Hints* : The following six matters should in particular be seen :—

(1) The main Object Clause and other Object Clauses.

(2) The Authorised Capital and different classes of Shares

(3) The Borrowing Powers.

(4) Provisions regarding the number, remuneration, appointment, removal and retirement of Directors.

(5) Powers, remuneration and duties of Managing Agents, Secretaries and Treasurers or Manager.

(6) Rights of shareholders.]

27 Explain the steps you would take, as Auditor of a limited company carrying on business as wholesale distributors, to satisfy yourself that all current Liabilities and Provisions are included in the Balance Sheet

(Chartered Accountants)

[*Hints* : The following measures should be adopted :—

(1) Checking the Purchases Book with original invoices, particularly of the last month of the Accounting period, and holding inquiry into the system of "internal check" in operation.

(2) Checking the list of Sundry Creditors, by reference to the Creditors' Ledger and confirmation of balances from those whom the company owes.

(3) Checking the entries in the Goods Inward Book with original invoices.

(4) Checking all the payment vouchers up to three months subsequent to Balance Sheet date.

(5) Checking the expenses like Rent, Telephone, Electricity, Loan Interest, etc., and seeing that all liabilities have been included in the Final Accounts.

(6) Vouching all expenses in connection with Directors' Remuneration, Managing Agents' Remuneration, Current Taxation, Audit Fees, etc., and verifying that all expenses have been included in the Accounts.

(7) Making inquiry about provisions being made for Proposed Dividends, Interest on Bank Overdraft, and for Bills Payable.

(8) Obtaining a Certificate from the Secretary of the company that all Liabilities have been provided in the Final Accounts.]

28. The Directors of a company, carrying on business as Building Contractors, have decided to make a further issue of Shares for Cash. They intend to announce this when the Annual Accounts are sent to the Members.

In view of the proposed issue, they are considering the following proposals which have been made for revision of the draft Accounts :—

(1) That the Plant and Equipment should be included in the Balance Sheet at the amount shown by a professional valuer, which is £20,000 in excess of the book value.

(2) That the valuation of uncompleted Contracts, included in previous Accounts at cost, should be revised so as to include a proportionate part of the estimated profit on the Contracts.

As Auditor, you have been asked for your views on these proposals.

You are required to write a letter to the Secretary—

(a) explaining the points which you consider should be brought to the attention of the Board with regard to the proposals ; and

(b) indicating the Adjustments which you consider should be made in the Annual Accounts if the proposals are adopted. *(Chartered Accountants)*

[*Hints* : To increase the book value of Plant and Equipment to the amount as valued by a professional valuer means 'unrealised capital appreciation' which is not justified unless excessive depreciation was provided in the past. If it is done, the fact should be disclosed in the Balance Sheet with full narration. To include estimated profit on uncompleted Contracts would mean a change in the 'basis of valuation' and should not be recommended, because this will inflate profits. If, however, the profit is included, corresponding expenditure on such Contracts should also be taken in the Accounts, and the Profit and Loss Account must disclose the fact clearly, so that the Members would be in a position to know of the source of the profit.]

CHAPTER XIV

THE LEGAL STATUS OF AN AUDITOR AND HIS LIABILITY

The Auditor is in a fiduciary position, the interests of his client being trusted to his care. It is his sacred duty to be diligent enough to detect errors and omissions in the Accounts and thereby protect the interests of the party that appoints him. The position of the Auditor is analogous to that of an agent and also to that of a trustee. An Auditor, therefore, has to exercise reasonable skill and industry in his work to the same extent as is expected of an agent working for his principal, or of a trustee working for his beneficiary. The responsibility of a Company Auditor is all the greater inasmuch as he has to uphold the interests of Shareholders who usually stay away from the day-to-day administration of the affairs of a Joint Stock Company. Wherever a person is entrusted with a task under an agreement, a liability devolves on him if he fails to do his task properly. So to determine the liability of an Auditor, it should always be seen whether he was careful enough in the execution of his job in keeping with a *reasonable standard*. Where it is established beyond doubt that the Auditor has been guilty of negligence, he may be asked to compensate his client for the loss resulting from his negligence. What is *reasonable care* and what should be called *negligence* must always be decided upon with due reference to the entire set of facts and circumstances of a particular case.

The extent of an Auditor's liability

To help determine whether in a particular instance the Auditor was guilty of negligence or not, certain well-known Audit Case Laws are often cited. Most of them are from the English Courts and the rest from the Courts of Law in India. A *Case Law* is the law declared and pronounced from judicial decision. Law-making is a function entrusted to that organ

of a Government which is known as Legislature or Parliament, and the Courts, being constituent parts of a different organ, called Judiciary, should not have any rôle in the passing of laws. But the bulk of the common law is still Judge-made. The Judges do not just legislate, nor do they introduce new principles. The existing principles, either of Customary Laws or of Statutes, are applied to each new set of facts that come before the Judges for adjudication and award. The recorded decisions of Judges on various aspects of Audit work should be carefully preserved and drawn upon for guidance in *similar* cases. The exact legal position of an Auditor is fraught with complexity. Wherever the prevalent Acts of Parliament are found to be inadequate, the Court's decision in an identical case would serve as a precedent. To find out a proper precedent, each concrete case should be dissected and analysed with full regard to its context. If this context and the remarks of Judges are minutely studied, an answer would be found for the *apparently conflicting* court awards. Thus, one would not be slow to understand why in *The Westminster Road Construction and Engineering Co., Ltd.* case (England, 1932) the Auditor was found guilty of negligence for blindly accepting a certificate from the Management, thereby having failed to detect (in spite of ample evidence being available) overvaluation of assets like Work-in-Progress &c., and under-valuation of certain liabilities, when decision of the court in *The Kingston Cotton Mill Co.* case was toward justifying the conduct of the Auditor in accepting a certificate from the Management as to the taking of Stock. The decision emanating from a Court of Law creates a precedent having a binding force in parallel cases which might in future be brought to court for a settlement. This binding force of a precedent has its basis and strength on the reason put forward by the Judge in arriving at his decision. The explanation of the reason that prompts judgment, in legal phraseology, is known as *Ratio Decidendi.* A distinction between *Ratio Decidendi* and *Obiter Dicta* is of importance. While the former means a statement of the reason and the principle behind a decision, by the latter should be meant the remarks made by the Judge in passing.

The *Importance* and *Weight* of Audit Case Laws

What is said in passing or cursorily may be of little bearing to the actual case under study, but is important to the person giving the verdict for his own purpose. The following Audit Case Laws are worth being studied.

In re **London and General Bank (No. 1)** (1895, 2 Ch. 166). The essence of the decision arrived at in the above named case was that *an Auditor should be called an officer of the Company* that appointed him. The Articles of Association of a Banking Company, registered under the Companies Act 1879 of England, referred to the Auditor as an officer of the Company several times, and the judgement was somewhat influenced by such mentions in the Articles. The arguments and remarks advanced by the Judge should be perused. Part of the judgement ran as follows : "........An Auditor is an officer of the Company. He is appointed by the Company, he is paid by the Company........ He is not a servant of the Directors. On the contrary, he is appointed by the Company to check the Directors, and for some purposes, and to some extent, it seems to me quite impossible to say that he is not an officer of the Company."

A Case Law on the question of whether an Auditor should be called an officer of the Company

In re **London and General Bank (No. 2)** (1895, 2 Ch. 682). In this case dividend was declared on the basis of 'profits' that included interest on certain objectionable advances made by the Bank. Customers of the Bank were lent moneys on insufficient securities, and the interest on such advances was credited to Profit and Loss Account, although it was not realised. The Directors' attention was drawn to the irregularity but they paid no heed. The Auditor's duty was to have the matter reported to the shareholders which he did not care to do. In the opinion of the learned Judge, the Auditor failed to discharge his duty. As was fittingly observed, the Auditor's duty would be not merely to verify the arithmetical accuracy of the Balance Sheet as prepared from the Books of Accounts. Certainly, it would be part of his duty to inquire whether the Books themselves reflected the true picture. *The Auditor, Mr. Theobald, was found guilty of misfeasance as he*

A Case Law where the Auditor was found guilty of misfeasance

failed to report to the shareholders of the fact that the Balance Sheet was not properly drawn up, and made evasive remarks with these words—'The value of the Assets as shown on the Balance Sheet is dependent upon realisation........'

Leeds Estate Building and Investment Society, Ltd. *v.* **Shepherd** (1887, 36 Ch. D. 787). In this case, a complaint against the Directors, the Manager and the Auditors was lodged alleging improper payment of dividends when actually there was no profit. The Accounts were made to 'show profits' for several years through inclusion of fictitious items. The motive was to pay a handsome remuneration to the Directors, this remuneration, according to the Company's Articles of Association, being payable in proportion to the dividends declared. The Articles also provided that no dividend could be paid except out of profits. The Auditor's failing was that *he did not ask for the Articles* while he examined the Accounts. The company that brought the action dealt in Loans, and lent money on mortgage.

A Case Law on Auditor's duty regarding Examination of the Articles of Association

The Judge, Stirling J., observed that *the Auditor had failed in his duty by not caring to s the Articles of Association.* He knew of the existence of this vital document, and he ought to have remembered that it would always be the bounden duty of every Company Auditor to verify whether all of the provisions of the Articles had duly been complied with. Else, the Auditor should not have certified that the Balance Sheet exhibited the correct financial position of a company as on a particular date. A charge of negligence would be levelled against the Auditor if he chose to rest contented with mere arithmetical accuracy of the Books of Accounts and of the Balance Sheet and did not exert himself to check up if the Balance Sheet represented the company's affairs truly and accurately.

In re **Kingston Cotton Mill Co., Limited** (1896, 1 Ch. 331). "........It is no part of the Auditor's duty to take 'stock'. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand.·......" "........An Auditor is not bound to be a detective,........He is a

watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company........" The foregoing are extracts from judgements delivered in the well-known English case (discussed earlier in Chapter VIII) that is under review a second time here, the former coming from Lindley, L. J., and the latter from Lopes, L. J. The comments of the learned Judges throw much light on the duty of the Auditor in the matter of verification and valuation of 'stock'. The profits of a Cotton Mill company were deliberately increased for making it appear flourishing, by manipulation of the quantities and values of the Closing Stock, and the Auditors did not take trouble to check the 'stock' properly, but accepted the Stock Certificate as given by the mill manager. The essence of the award of the Court was that the Auditors could not be held responsible for incorrectness in 'Stock Valuation', as they allowed insertion of the Stock-in-trade as an Asset on the face of the Balance Sheet with the remark : *as per Manager's Certificate*. An Auditor, certainly, would not be expected to approach his work with suspicion, or with a foregone conclusion that there was something wrong. Hardly could there be anything objectionable in relying upon the statements made by the trustworthy employees of the client, in the absence of suspicious circumstances. The position of an Auditor would be intolerable if he were called upon to verify each and every item of 'Stock', having first been well-versed in the technicalities of his client's trade and the goods dealt in. So the Auditors were set free as they could not be held liable for not tracking out ingenious and carefully laid schemes of fraud.

A Case Law on Auditor's liability as to verification and valuation of 'Stock-in-trade'

Centring round the question of the Auditors' duties and responsibilities in the matter of physical verification of the quantities and the condition of 'stock', a divergence of opinion exists in the world of Accounting and Audit. Some take the position that the verification of inventories (detailed list of goods, etc.) will be done only with reference to the records. Others hold the opposite view. According to them, either through test-counting (or measuring) or through the exercise of a vigilance over the taking of Stock, the Auditor should

establish a direct contact with the inventory. For *not doing a physical verification of inventories* and for not checking up the valuation, the Auditors were found guilty of negligence in the American case, *McKesson v. Robins* and also in an English case narrated below.

A Case Law on the Auditor's Liability in respect of 'over-valuation of Work-in-Progress' and 'under valuation of certain Liabilities'

In re **The Westminster Road Construction and Engineering Co., Ltd.** (1932, Acct. February 1932, pp. 203-4). An Auditor is not a stocktaker, nor should he be expected to be a valuer of 'work-in-progress'; still he would incur liability if there was overvaluation of 'work-in-progress' which the Auditor could easily detect by reasonably utilising the available evidence. The above is the essence of judgement delivered in a case where the Auditors had also acted as Accountants to the company under Audit. Charges were framed by the liquidator of the company against the Directors and the Auditors, alleging improper payment of dividends for the year ended 31st March, 1928 when there were no profits, and claim was filed for recovery of dividend. The accounts were made to show a distributable surplus through (i) *understatement of the company's liabilities*, and (ii) *overstatement of the value of 'work-in-progress'*. The Court found the Auditors guilty of negligence, but set the Directors free as they had all believed in the Accounts and the Balance Sheet certified by the Auditors.

According to the Judge, Bennett J., the understatement of liabilities could be detected if the Auditors *had gone through the invoice files* of the company in order to see that no invoices relating to liabilities had been omitted. As to the other failing, viz., non-detection of the overvaluation of 'work-in-progress', the Judge remarked that the Auditors could have easily checked up the accuracy or otherwise of the stock figures presented before them, as there was *ample material to do such a test.*

McKesson *v.* Robins (1939). This case decision originating in a law court in the U.S.A. created a stir when it was found it had reversed the judgement as pronounced in the Kingston

An American Case Law that found the Auditors guilty for not doing a physical verification of 'Stock'

Cotton Mill case. The Court in the case of Kingston Cotton Mill Co., Ltd., held that it was not the duty of the Auditors to verify Closing Stock, in the absence of suspicious circumstances. In the McKesson & Robins case, however, the decision was that the Auditors must physically verify 'Closing Stock' appearing on the Balance Sheet, after obtaining an Inventory from the Management certified to the effect that the officials actually verified the 'Stock-in-trade' on the Balance Sheet date, and found them as stated in the Inventory. If the Auditors failed to do a physical verification, they would be found negligent of their duties and would be *liable for manipulation of Profit through Closing Stock*. It could not be possible, however, for the Auditors to verify the entire 'stock'. They, therefore, had to pick up big items from the Inventory, and make an on-the-spot verification by way of test counting (or measuring), to be sure of the existence of Closing Stock. It was held by the Court that the Auditors of the McKesson & Robins case had done a glaring wrong by unquestionably accepting the Stock Sheets furnished by the Management. The fact of the case was that the topmost person at the helm of affairs of a concern entered into a collusion with other officials and presented before the Auditors a bogus set of Stock-items. Consequently, there was a noticeable inflation in Stock valuation.

Since after the publication of the Case Law now under study, practitioners in the Accounting profession in the U.S A. have in large number taken to the practice of bringing the actual Stock under a physical test check. Some of the English Accountants have also begun lending support to a practice of this sort. In the opinion of the Authors, it would not be in the fitness of things for the Auditors to place entire reliance upon the Certificate had from the Management in respect of such an important Balance Sheet item as Stock-in-trade where the scope of manipulation is so wide. So a test check has, of necessity, to be applied. Where the circumstances give rise to a suspicion that something went wrong somewhere, the Auditors may have to undergo the strain of conducting a full and detailed physical check.

The London Oil Storage Co., Limited *v.* **Seear, Hasluck & Co.** (1904, Acct. L. R. 30, 93). In the judgement of this case, it was pointed out that the Auditor would be liable for damages, if he omitted to verify the existence of any Asset as shown on the Balance Sheet. The Auditor's clerk did not count the balance of Petty Cash in hand. The balance as per Petty Cash Book should have been £796, while the amount actually in hand was £30. The Secretary of the company who maintained the Petty Cash Book made a misappropriation of the difference and hence, the shortage. A special jury that sat over the hearing disapproved of such a large cash balance remaining in the hands of the petty cashier, and because of this fault on the part of the Directors, the damages awarded against the Auditor were not of a heavy amount The Judge, Alverstone C.J., however, remarked in the course of his summing up, "The conduct of the Directors is no answer to any breach of duty by the defendant ....". In this case the Auditor was the defendant. The liability for loss of money sustained by the company rested on the Auditor and not on the Directors though their conduct was responsible for the loss It was, therefore, *established that the Auditor had committed a breach of duty.* The fact that there was a want of proper control over the man stealing the money could only go to make the punishment light.

A Case Law on a breach of duty by the Auditor arising through *non verification of 'Petty Cash in hand'*

Arthur E. Green & Company *v.* **The Central Advance and Discount Corporation, Ltd.** (1920, Acct. L. R. LXIII, p. 1). The facts of the case were that a list of bad and doubtful debts was furnished by the Management of the client company whose business was money-lending. The Auditors, Arthur E. Green & Company were found guilty of negligence, as they had not enquired of the other debts outstanding for a pretty long time, some being actually statute-barred and, therefore, irrecoverable. As His Lordship *observed, an Auditor must not fail to make a proper enquiry, by merely relying on what a trustworthy official says.* To fulfil his duty owing to the

A Case Law on the Auditor's guilt of negligence in accepting an incomplete schedule of 'bad debts' furnished before him

Company, he should qualify his Report to the Members wherever the circumstances of the case warrant this.

Under the case, the Auditors were asked to pay damages as, through insufficient provision for bad debts, the profits got inflated and commission was paid to the Manager of the company on the basis of inflated profits.

A Case Law on Auditor's duty and liability regarding *verification of Investment in Securities* where *window-dressing* operations were at play

In re **The City Equitable Fire Insurance Co., Ltd.** (1924, Acct. L. R. 53 and 81). The case under study is of great interest to the Accounting world. The City Equitable Fire Insurance Co., Ltd. had re-insurance business. An insurer generally has to make investments in Government Papers and other approved Securities, and in this case a firm, named Ellis & Company, was appointed the Insurance Company's Stockbrokers*. The chairman of the City Equitable Fire Insurance Co., Ltd., Mr. Bevan, was also a senior partner at Ellis & Company.

The Official Receiver, as liquidator of the company, brought action against the Directors and the Auditors. The action against both parties was dismissed at the Lower Court. The case was taken to the Court of Appeal only against the Auditors. And here, too, the Auditors were freed from liability.

Centring round certain objectionable transactions of Loans, &c., between the Insurance Company and its firm of Stockbrokers, *a threefold charge*, as indicated below, was framed :—

(a) To the General Manager of the Insurance Company, Mr. Mansell and to the Stockbrokers large sums were advanced as *Loans*, and these were wrongly described as 'Loans at Call or Short Notice', *or* 'Loans' (the names of parties not being given) *or* 'Cash at Bank and in Hand'. This misdescription appeared for three consecutive years on the face of the Balance

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* Stockbrokers are middlemen through whom Shares and other Securities are bought and sold at the Stock Exchange, both for investment purposes and for speculation.

Sheets prepared as on 28th February 1919, 28th February, 1920 and on 28th February, 1921. The result was that the shareholders could not know of the existence of the above mentioned debts from the Balance Sheet.

(b) The fact that much larger sums were in the hands of Ellis & Co. at the date of each Balance Sheet than were shown among the Assets, escaped notice of the Auditors. This could be possible as there was a clever manipulation. On the closing date the Insurance Company used to call back a large portion of the amounts due from the Stockbrokers, only temporarily, this being returned the next opening day.

(c) The Auditors failed to detect, and, therefore, failed to report to the shareholders, another important fact. The fact was that Ellis & Co., who were custodians of the securities of the Insurance Company, used to borrow money from the market by pledging these securities without any authority.

With regard to the first charge, the observation of the Judge was that the misdescription was not of a serious nature as it did not involve any damage to the company. Besides, it was pointed out that even if the Assets were all correctly described, in the circumstances of the case, it would not have made any difference to anybody. So the Auditors were not to blame so much especially because, in the opinion of the Court, they in general had displayed great care, skill and industry. To make loans to parties closely connected with a company was a question of policy for the Directors, and the Auditors had very little to do in the matter. If, however, a debt was not a good one, proper provision for it had to be made. But in this case, there were no grounds for assuming that the debts advanced to Ellis & Co., or to Mr. Mansell were doubtful, their financial position being quite sound. *As to the second charge*, it was discovered that a regular "window-dressing" operation was at work. Ellis & Co. carried on such an operation by making a pretended purchase of securities like Treasury Bonds, National

War Bonds, &c., just before the Balance Sheet date and by feigning to resell them after close of the financial year of the Insurance Company. The Stockbrokers hardly touched these securities, they remaining with the sellers by way of pledge, for loans granted to the former (Ellis & Co.). The judge did not find the Auditors blameworthy for not detecting this cleverly contrived plan. So, like the first charge, the second one, too, failed. *As regards the third charge,* the Court did not hesitate to lay blame at the door of the Auditors. Certainly, Messrs. Langton & Lepine, the Auditors of the present case, had not done their duties in connection with the custody and inspection of Securities. Part of Mr. Justice Romer's observations runs as follows : "........*An Auditor is not in my judgement ever justified in omitting to make a personal inspection of Securities that are in the custody of a person or company with whom it is not proper that they should be left........*" A company's brokers could not be called the proper persons to have custody of its securities, however respectable and responsible they might be. Except for short periods, the Securities must not be left with the brokers, and the Auditors must not rely on the certificate given by the brokers, wherever personal inspection would be possible. While giving his award, the Judge of this case referred to Lord Justice Lindley's judgement in the *London & General Bank* case, discussed earlier in this chapter. No punishment was, however, inflicted on the Auditors, as according to a certain Article of the British Companies Act, the Auditors and other officials of a company would be given protection by law unless they were guilty of wilful negligence. The court held that the Auditors of the City Equitable Fire Insurance Co., Ltd. had not done anything bordering upon 'wilful negligence'. They had rather laboured under a mistaken belief as to what their exact duty was.

Armitage v. Brewer and Knott (1932, 87 Acct., p. 836). Under the case, frauds of an audacious nature were perpetrated by Miss Harwood, an employee of the firm 'Brewer and Knott', who was in complete charge of the Books of Accounts and payment of wages, there being no system of internal check. The case under review has an important bearing on the Auditor's duties in respect of vouching and verification of entries passed

in the Account Books. The Auditor could not discover the defalcations done, although a continuous and detailed Audit was in operation. As it was not the case of a limited company Audit, the exact arrangement between the Auditor and the client had to be looked into. The plaintiff of this case had told the Auditor that protection against petty frauds would always be wanted. The documents showed that the Auditor was to have vouched all payments of petty cash by reference to the Receipts, and *was to have guarded against falsification of wage sheets in all possible ways.* The Auditor was found guilty of negligence. The Court held the view that the fraud could have been easily detected, had the Auditor exercised but reasonable care and vigilance in the vouching of entries done in Account Books. " .. ....A 6s. 1d. had been altered to 16s. 1d. That was passed in what purported to be a meticulous examination. The most casual inspection would detect the discrepancy on the voucher. ..... " – so did His Lordship remark in his judgement.

A Case Law on the Auditor's lack of care and vigilance in respect of vouching and verification of entries in Books of Accounts

The Irish Woollen Co. Limited *v.* **Tyson and Others** (1900, 27 Acct., L. R. 13). The subject matter of the case was that a fictitious Profit was shown by suppression of purchase invoices, the goods bought being taken into stock. The invoices were carried over and ultimately posted to Ledger under false dates. According to the observations of the Judge, the fraud could have been discovered by the exercise of reasonable care and skill during Audit. In the opinion of the Lower Court and also of the Court of Appeal, the Auditor, Mr. Kevans could have easily detected the falsification of Accounts, had he only cared to call for the Creditors' Statement of Accounts, on the basis of which payments were made, and compare them with the Ledger. Also he ought to have checked the postings into Ledger Accounts with the invoices. So, the Auditor was held liable for damage sustained by the company due to falsifications.

A Case Law on the Auditor's liability for non-detection of falsification of Accounts that could have been discovered by reasonable care and skill

Pendleburys Ltd. *v.* **Ellis, Green & Co.** (1936, Acct., 28th March, 1936, p. 480, *et seq*). This was a case where the Auditors were unable to check fully all of the transactions relating to cash sales and wage payment. The Auditors' plea was that there was no proper internal check, and adequate records were not maintained. The Directors' attention was drawn to loopholes in the organisation. Pendleburys Ltd. was a Private Limited Company with three Directors who were the only shareholders. The Cashier defalcated money from 'Wages' and 'Cash Sales' which was discovered later on, and the Directors brought this suit, claiming damages from the Auditors, the allegation being of negligence of duty. It was held by the Court that the Auditors were not guilty of negligence of duty, and as such they were not liable for damages. Ellis, Green & Co., therefore, stood exonerated on the ground that they had duly reported of the defects in the Accounting system to the Directors besides whom there was no other shareholder in the Private Limited Company.

A Case Law on Auditors' Liability where they reported of the defects in the Accounting system to the Directors who were the sole shareholders

Stapley *v.* **Read Bros., Ltd.** (1924, 40 T. L R. 442). Read Bros. Ltd. had written off the debit balance of Goodwill Account against "Reserve" Account in 1918. During the years 1921 and 1922 the company had sustained losses, but the year 1923 was one of 'profit'. The Directors proposed to restore the Goodwill Account by debiting it and correspondingly crediting the Reserve Account. It was further proposed to utilise this 'Reserve' Account for wiping off the Profit and Loss Account debit balance of 1921 and 1922 and payment of dividends to Preference Shareholders for the years 1921, 1922 and 1923. One Ordinary Shareholder brought this case for an injunction to stop the Directors from the payment of such dividends. The Court held that there was nothing in law to prevent the Directors from making payment of dividends to the Preference Shareholders out of current profits, when trading losses of previous years were adjusted against a Reserve Account created through re-appearance in the Accounts of 'Goodwill' earlier written off.

A Case Law on irregularity or otherwise in paying dividends out of current profits

Apfel *v.* Annan Dexter & Co. (1926, 75 Acct., 687). In this case a claim was made against Annan Dexter & Co., a firm of Chartered Accountants, for damages. The facts were that two sons of Mrs. Adele Apfel had robbed her of considerable amounts which the above named firm failed to detect. It was the contention of the defendants that they had acted not as Auditors but as Accountants. Hence, it was beyond their scope to discover the fraud as complained of by the plaintiff. They were appointed to prepare the Accounts for submission to the Income-Tax authorities. It was held by the Court that Annan Dexter & Co could not be found liable for damages. They acted in the capacity of Accountants only. The responsibility of detecting the foul means resorted to by the sons of Mrs. Apfel did not, therefore, rest with the firm of Chartered Accountants. The case under review amply demonstrated that a world of difference did exist between the scope of Accounting work and that of Audit work.

A Case Law on the difference between the scope of work of an Accountant and that of an Auditor

Leech *v.* Stokes (1937, 81 Acct. L. R. 87). As in the preceding case, here, too, action was brought against a firm of Accountants for failure to detect misappropriations of cash by the Cashier in a firm of Solicitors ; and the defendants were found not-guilty as they had not been appointed for conducting an Audit. The Cashier had control over cash collections done by the Solicitors' firm on behalf of their clients, and he misappropriated large sums. This did not come to light because the Books of Accounts had not been properly kept and because no investigation had been carried out.There was neither a Cash Book nor a Ledger containing Accounts of the Solicitors' clients. The only Book that was available was a Costs Furnished Book. In this Book were recorded : (a) all expenses incurred for the clients, and (b) weekly summaries of the expenses of the firm. From the particulars so available the defendants (the firm of Accountants) could prepare only the Profit and Loss Accounts. From the incomplete record of transactions no Balance Sheet could be prepared.

A Case Law on failure to detect fraud by a firm of Accountants instructed only to prepare a 'Report of Profits' for the Inspector of Taxes

The Accountants were instructed to prepare Annual Profit and Loss Accounts for the Solicitors' firm for Tax purposes. It was not necessary for the defendants to make an investigation because that was beyond the scope of their work. Hence, the defendants could not be made responsible for the defalcation of cash. In the course of his judgement His Lordship observed, "In this case there was no proper Book-Keeping material available for the preparation of a Balance Sheet and that there was no actionable negligence or breach of duty on the part of the defendants in any of the matters relied upon." The court held that the defendants could not be made responsible for the misappropriation of cash. As in *Apfel* v. *Annan Dexter & Co.*, through the decision of the present case also, a clear line of demarcation was drawn between the duties of an Auditor and those of an Accountant.

Scarborough Harbour Commissioners *v.* **Robinson, Coulson, Kirkby & Co.** (1934, Acct. L. R. 65). The Auditors of the Commissioners failed to detect Bad Debts during the Audit and did not report this fact to them. G. Sellers & Co. Ltd., fish salesmen, were tenants of Scarborough Harbour Commissioners. The former had arrears of rent and of amounts due for gas and sale of fish. The total of the amounts due was £351 which was considered bad. The Auditors never commented on this fact.

A Case Law on the Auditors' being exonerated from the charge of breach of duty for non-reporting to shareholders of the irrecoverability of certain book debts

The Commissioners brought this case against the Auditors to recover the above mentioned amount, because they had failed to do their duty. Mr. Justice Crossman held that the Auditors should have reported to the Commissioners about the existence of this bad debt. Also they ought to have inserted a note in the Balance Sheet to that effect. Auditors were found guilty of negligence of duty by the learned Judge who issued instructions for an investigation being held in respect of damages sustained by the Commissioners. The Auditors made an Appeal against this judgement. At the Court of Appeal, Justice Romer during his judgement observed, "......I do not think it is necessary or that it was necessary for him (Auditor) to call attention specially to the fact (Bad Debt), having regard to

the inquiries he had made and the answers that he had received.......In my opinion the plaintiffs have failed to show that Mr. Robinson has been guilty of any breach of duty, and, in my opinion, this action should be dismissed with costs"

In re **Allen Craig & Co. (London), Ltd.** (1934, 50 T.L.R. 301). In this case action was brought against the Auditor for not submitting his Report directly to the shareholders. The facts were that the Audit Report was prepared in time and duly submitted to the Secretary of the company. No General Meeting was, however, convened by the directors and as a result, the Auditor's Report did not reach the shareholders It was held that the Auditor's duty was confined to forwarding his Report to the Secretary or the Directors. And that duty had been fully discharged. If the shareholders did not get the Report because there was no General Meeting held, the Auditor could not be made to share blame for this failure on the part of the Directors.

A Case Law which held that the Auditor's duty was confined to forwarding his 'Report' to the Secretary or the Directors

In re **S.P. Catterson & Sons, Ltd.** (1937, 81 Acct., L.R. 62). An employee of the company did extensive defalcations in respect of sales, not revealed by the Audit. The judge of this case did not find the Auditors negligent and acquitted them of liability for breach of duty. The points advanced by him were that there had been *fault on the part of a Director* in not realising from the employee, committing the fraud, the proceeds of sales done on behalf of the company. As the Judge rightly observed, the main responsibility for keeping the Accounts of a company in right order lay with the Directors. In the case under review, the Directors were found wanting in a proper sense of duty. The Auditors had drawn their attention to the loopholes subsisting in the system of recording certain sales and suggested remedies ; but, regrettably enough, the recommendations had been turned down.

A Case Law which established that the liability of the Auditor ceased as soon as he had drawn the attention of the Directors to the defects in the accounting method

B.N. Mohan *v.* K.C.J. Satyavadi. Sec. 225 of the Indian Companies Act (latest) deals with the question of appointment as

Auditor of a person other than the retiring Auditor. The requirements of this section are that a Special Notice must be served to the Company, by a shareholder when, by a resolution at an Annual General Meeting, a new person is intended to be appointed as the Company's Auditor. The company is to *send a copy of the notice* forthwith to the retiring Auditor. None of the above provisions of law was complied with in the present case, and the new Auditor did not care to ascertain from the company if the legal requirements were honoured. Besides, professional etiquette demanded that an Auditor appointed in place of another would, before taking up the Audit Work, communicate with the predecessor and know from him the reasons of his not being reappointed. In this case the new Auditor did, of course, enter into a communication, but only two weeks after acceptance of the appointment.

A Case Law on the Auditor's liability where he is appointed in place of his predecessor

As it was the first offence of its kind on the part of the Auditor, he was relieved of his liability with a strong note of warning and on his paying the legal costs of all the parties related to the case. The Court however, formed the opinion that the conduct of the new Auditor was open to objection and that such violation of professional courtesy would normally debar one from continuing to remain a member of the Institute of Chartered Accountants of India.

The Deputy Secretary, Department of Economic Affairs, Ministry of Finance, Government of India *v.* S.N. Dasgupta (1955, 60 C.W.N. 124). In this case the Auditor was found guilty of professional misconduct. He violated the regulations that the members of the Institute of Chartered Accountants of India are to conform to and this was a punishable offence. During the forties, a bank, named Aryan Bank, went into liquidation. The charge against the Auditor was that the Profit and Loss Account and the Balance Sheet for the years 1942, 1943 and 1944 signed by him did not exhibit a true and correct view of the Bank's state of affairs. The discrepancy lay in the fact that

A Case Law that found the Auditor guilty of professional misconduct punishable under sections 20(2) and 21(3) of the Chartered Accountants Act, 1949

the Auditor of the Bank had omitted to verify cash actually in hand and accepted instead a certificate from the Management. In the Audit of a Bank Balance Sheet, an exhaustive checking of cash in hand ought to be of imperative necessity. The Auditor had not exercised due skill or care in fulfilling this most important obligation of his. Failing to draw the attention of the shareholders to the unsatisfactory state of affairs of this Bank, he did a disservice not only to the shareholders that appointed him but to the cause of Joint Stock Companies in the country in general. A punishment of suspension from practice, for two years, was inflicted on him.

Superintendent and Remembrancer of Legal Affairs, Bengal v. Akhil Bandhu Guha and others (1936, 40 C.W.N. 1341). Akhil Bandhu Guha and two others were the Managing Directors of two companies, viz., Dhakeswari Cotton Mills, Ltd. and East Bengal Jute and Cotton Mill, Ltd. There were serious misdescriptions in the Balance Sheet of the former company for the year 1933. Large sums of money were advanced as loan to the latter company and this was never disclosed. Deposits used to be accepted by the Dhakeswari Cotton Mills, Ltd. from the customers as advance against orders and in the Balance Sheet of the company these Deposits were shown at a reduced figure on the Liabilities side, the loans granted to the other above named company being deducted therefrom. Another gross irregularity was that on the Assets side, under 'Advances to Contractors and others' loans given to the Managing Directors were merged, the fact of such loans not being shown on the face of the Balance Sheet. A case was instituted by the shareholders against the Managing Directors, the allegation being of a wilful making of a false statement in respect of the Balance Sheet. At the Magistrate's Court, all the three Managing Directors were found guilty and were sentenced to simple imprisonment for one week, and a fine of Rs. 500 each. On an appeal by the Managing Directors, the District Judge acquitted all of them, because he was of opinion that no criminal intention could be proved from the manner the Balance Sheet was drawn up. The Super-

A Case Law on the Auditor's liability for serious misdescriptions in the Balance Sheet and failure to make a proper disclosure of the asset items and the liability items

intendent and Remembrancer of Legal Affairs, Bengal* lodged an 'appeal' to the High Court against the order of the District Judge. In the course of his judgement, Justice Cunliff thus observed : "......It is quite obvious that a loan and a deposit are items differing completely in principle from the Balance Sheet point of view. Strictly speaking they ought to appear on different sides, for one is an Asset and the other is a Liability. Consolidating the two and presenting them as one item to the readers, to my mind, is a striking case of non-disclosure, amounting to suppression of truth........" The learned Judge retained the award of the first court, viz., the court of the Magistrate with only this modification that the period of imprisonment was increased to three months. On an appeal to the Local Government, the sentence of imprisonment was condoned.

The observation of another High Court Judge, Henderson T., hearing the same case was that the Balance Sheet was false and grossly misleading. The opinion of the Auditor that the Balance Sheet had been properly drawn up was, therefore, of no value whatsoever. According to Justice Henderson, the Auditor did not carry out his duties to the shareholders properly, as he had not pressed and called their attention to his objection about the advances improperly made by the Dhakeswari Cotton Mills, Ltd. to the East Bengal Jute and Cotton Mill, Ltd.

A Case Law in which the Directors and the Auditor were both found guilty for having signed an improperly drawn up Balance Sheet showing *fictitious loans and advances* as an Asset

In re **Union Bank of Allahabad, Ltd.** (1925 I.L.R. 47 All. 669). The Manager of the Union Bank of Allahabad, Ltd. made fictitious advances to several parties including his relatives, and also granted loans to various constituents which were shown as 'fully secured and considered good'. The Bank went into compulsory liquidation, and the Official Liquidator brought an action against the Auditor and the Directors of the Bank for payment of dividends out of fictitious profits resulting in payment of dividends out of capital. These advances and loans, as a matter of fact, were not at all secured, and hence,

* This officer is in charge of the judicial department of the Provincial Government, and has power to appeal against the judgements of lower courts to the High Court.

could not be considered good. On the contrary, the major portion of the moneys lent was irrecoverable. In the course of his judgement, Justice Walsh remarked : "I come without hesitation to the conclusion....that the Directors have failed to show that they had any reasonable belief and that they are liable, each of them for the payment which they approved either by Resolution or by signing the Balance Sheet, and the Report by which it was recommended, for dividends paid out of capital from 1915 to 1923.....In my opinion, Mr. De was guilty of signing a false statement of a Balance Sheet as Auditor. Unless Auditors are to be held strictly to their legal liability, however honest they may be, the object of the Legislation in requiring a certificate from them is absolutely defeated.....

It was held by the Court that both the Directors and the Auditors were liable for the payment of dividends out of capital through falsification of Accounts.

The Registrar of Companies, Bombay v. P.M. Hedge (1954, 'The Chartered Accountant', Vol. II, p. 604). The Auditor, Mr. P.M. Hedge, of the Rural Bank of India, Ltd. was prosecuted, because he had failed to report to the shareholders of the true and fair view of the state of affairs of the Bank. On the Balance Sheet dates, the Auditor did not verify the 'Cash in hand' at the Head Office for the years 1945-49. As a matter of fact he verified Cash about five weeks later than the dates of the Balance Sheets, and never checked the cash transactions of the intervening periods. Besides, he failed to report to the shareholders of the fact that the provisions of the Companies Act were not complied with in respect of amount received from applicants for Shares of the Banking company which should have been deposited into a Scheduled Bank and kept earmarked until the company got permission to commence business. The Managing Director of the above named Bank was also the Manager of an Investment Company. During investigation it was found that the Share Application Money of the Bank was wrongly applied and that fictitious deposits were shown in the Investment Company's books to be made use of for purchasing

A Case Law on non-Verification of 'Cash in hand' and non-Detection of 'window-dressing'

Shares of the Bank. Also was revealed that Loans and Advances—all sham and unreal—appeared as Assets in the Bank's books. The Auditor failed to detect the irregularities including the 'window-dressing' on the Balance Sheets of the Bank. To put it in the words of Their Lordships : "The very failure to deposit the moneys should have roused his (Auditor's) suspicion, and very probably a searching inquiry would have revealed the fact that the major allottees of the Shares had not paid for the large number of Shares allotted to them. We, therefore, agree with the Council of the Institute of Chartered Accountants that the Respondent (Auditor) failed to discharge his duty as an Auditor of The Rural Bank of India, Ltd., and he was guilty of gross negligence." It was, however, held by the Court that as the Auditor was not found guilty of moral turpitude, only a warning should be meted out to him.

A Case Law on the Auditor's liability for failure to make a physical verification of Securities held by the client

In re **G.M. Oka** (1925, *The Chartered Accountant*, Vol. I, pp. 40-42). Trinity Mutual Assurance Co., Ltd. was directed by the Assistant Controller of Insurance to furnish a certificate from the Auditors of the company as to the Securities held by the company as at 31st. December 1949. Mr. G.M. Oka, the Auditor, gave a certificate as required The book value of the Securities held by the company as certified by the Auditor was shown at Rs. 5,98,400 which was wrong. For, a part of the Securities valued at Rs. 1,00,000 was pledged with a Bank as security against an overdraft. Thus the Insurance Company had not been holding the minimum value of Securities as required by the Insurance Act of 1938. The Auditor never made a physical inspection of the Securities and failed to report that a part of the Securities was pledged with a Bank against an overdraft.

It was held by the Court that the Auditor was liable for professional misconduct and that his practising licence be cancelled for six months because he had failed to verify the Assets. In the course of his judgement, Justice Chagla remarked, "The very defence and the very explanation renders the Auditor unfit to continue as a Member of the Institute of Chartered Accountants.....His certificate, his signature, his

verification carry great weight, and they are usually accepted as correct and genuine. In this particular case the Assistant Controller of Insurance accepted the certificate, did not prosecute the Insurance Company, and it was only when it was found out by the Assistant Controller that the certificate was not genuine, and that he had been misled and deceived, that he preferred a complaint to the Institute of Chartered Accountants. Under the circumstances, we think that the proper order we should pass is that the name of the Auditors shall be temporarily removed from the Register of Chartered Accountants for a period of six months."

A Case Law on the Auditor's liability in the matter of wrong showing of Preliminary Expenses (the organisation expenses not having been verified properly)

Baidya Nath *v.* Emperor (1935, A.I.R., Cal. 741). In the early years of a company after the commencement of business only formation expenses should be charged to *Preliminary Expenses*. In order to show more profits, if 'incorporation expenses' are charged to Preliminary Expenses, instead of to 'Revenue', the provisions of the Companies Act will be violated, and the Balance Sheet and the Profit and Loss Account will not exhibit a true and fair view of the state of the affairs of the company. In this case the Auditor certified a Balance Sheet in which the Preliminary Expenses were shown incorrectly, because a part of Revenue Expenses were incorporated under this head, thus *inflating the trading profits.*

It was held by the Court that it was the duty of the Auditor to verify the organisation expenses. Otherwise, he would commit a technical offence under the Companies Act for certifying a Balance Sheet containing false statements.

A mention of the Case Laws discussed in the foregoing Chapters

Certain Case Laws have in earlier chapters been dealt with in this book. To avoid making the present work a voluminous one, an introduction of them a second time in this Chapter has not been done. Here are given only their citations and the Chapters under which they have earlier been discussed. All of these cases have their bearing on the question of the Auditors' liability.

Chapter IX: Depreciation

(i) Lee *v.* Neuchatel Asphalte Co., Ltd. (1889, 41 Ch. 1).

(ii) Verner *v.* General and Commercial Investment Trust, Ltd. (1894, 2 Ch. 239).

(iii) Wilmer *v.* McNamara & Co., Ltd. (1895, 2 Ch. 245).

(iv) Bond *v.* Barrow Haematite Steel Co., Ltd. (1902, 1 Ch. 358).

(v) Crabtree, Thomas *v.* Crabtree (1912, 106, L. T 49).

Chapter X: Reserves and Sinking Funds

(i) Arthur E. Green & Co. *v.* The Central Advance & Discount Corporation, Ltd. (1920, Acct. L. R. LXIII, p. 1).

(ii) Dovey *v.* Cory (*National Bank of Wales case*) (1901, A. C. 477).

(iii) Newton *v.* Birmingham Small Arms Co., Ltd. (1906, 2 Ch. 378).

(iv) Rex *v.* Kylsant and Morland (*Royal Mail Steam Packet Co., Ltd. case*) (1931, Acct. p. 109 *et seq.*).

Chapter XI: Payment of Dividends

(i) Foster *v.* The New Trinidad Lake Asphalte Company, Ltd. (1901, 1 Ch. 208).

(ii) Lubbock *v.* The British Bank of South America, Ltd. (1892, 2 Ch. 198).

(iii) Bolton *v.* Natal Land and Colonisation Co., Ltd. (1892, 2 Ch. 124).

(iv) Ammonia Soda Co., Ltd. *v.* Chamberlain and Others (1918, 57 Acct. L. R. 14).

Liabilities incurred by a Company Auditor under certain Sections of the Companies Act. A number of Sections are quoted here verbatim from the Companies Act. These Sections dwell on the liabilities that the officer of a company may incur under particular eventualities. To guard against running into a liability, an Auditor would always do well to

carefully go through the contents of the cited Sections ; for, he will be treated as an officer of the Company whose Account Books are under his Audit.

Power to summon persons suspected of having property of company, etc.

477. (*1*) The Court may, at any time after the appointment of a provisional liquidator or the making of a winding up order summon before it any *officer* of the company or person known or suspected to have in his possession any property or books or papers, of the company, or known or suspected to be indebted to the company, or any person whom the Court deems capable of giving information concerning the promotion, formation, trade, dealings, property, books or papers, or affairs of the Company.

(*2*) The Court may examine any *officer* or person so summoned on oath concerning the matters aforesaid, either by word of mouth or on written interrogatories ; and may, in the former case, reduce his answers to writing and require him to sign them.

(*3*) The Court may require any *officer* or person so summoned to produce any books and papers in his custody or power relating to the company ; but, where he claims any lien on books or papers produced by him, the production shall be without prejudice to that lien, and the Court shall have jurisdiction in the winding up to determine all questions relating to that lien.

(*4*) If any *officer* or person so summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the Court at the time appointed not having a lawful impediment (made known to the Court at the time of its sitting and allowed by it), the Court may cause him to be apprehended and brought before the Court for examination.

[1][(*5*) If, on his examination, any *officer* or person so summoned admits that he is indebted to the company, the Court may order him to pay to the provisional liquidator or, as the case may be, the liquidator at such time and in such manner

[1] Ins. by Act 65 of 1960. s 176.

as to the Court may seem just, the amount in which he is indebted, or any part thereof, either in full discharge of the whole amount or not, as the Court thinks fit, with or without costs of the examination.

(*6*) If, on his examination, any such *officer* or person admits that he has in his possession any property belonging to the company, the Court may order him to deliver to the provisional liquidator or, as the case may be, the liquidator, that property or any part thereof, at such time, in such manner and on such terms as to the Court may seem just.

(*7*) Orders made under sub-sections (5) and (6) shall be executed in the same manner as decrees for the payment of money or for the delivery of property under the Code of Civil Procedure, 1908, respectively.

(*8*) Any person making any payment or delivery in pursuance of an order made under sub-section (5) or sub-section (6) shall by such payment or delivery be, unless otherwise directed by such order, discharged from all liability whatsoever in respect of such debt or property.]

Power to order public examination of promoters, directors, etc.

478. (*1*) When an order has been made for winding up a company by the Court, and the Official Liquidator has made a report to the Court under this Act, stating that in his opinion a fraud has been committed by any person in the promotion or formation of the company, or by any *officer* of the company in relation to the company since its formation, the Court may, after considering the report, direct that that person or *officer* shall attend before the Court on a day appointed by it for that purpose, and be publicly examined as to the promotion or formation or the conduct of the business of the company, or as to his conduct and dealings as an *officer* thereof.

(*2*) The Official Liquidator shall take part in the examination, and for that purpose may, if specially authorized by the

Court in that behalf, employ such legal assistance as may be sanctioned by the Court.

(*3*) Any creditor or contributory may also take part in the examination either personally or by any advocate, attorney or pleader entitled to appear before the Court.

(*4*) The Court may put such questions to the person examined as it thinks fit.

(*5*) The person examined shall be examined on oath, and shall answer all such questions as the Court may put, or allow to be put, to him.

(*6*) A person ordered to be examined under this section—

(*a*) shall, before his examination, be furnished at his own cost with a copy of the Official Liquidator's report ; and

(*b*) may at his own cost employ an advocate, attorney or pleader entitled to appear before the Court, who shall be at liberty to put to him such questions as the Court may deem just for the purpose of enabling him to explain or qualify any answers given by him.

(*7*) (*a*) If any such person applies to the Court to be exculpated from any charges made or suggested against him, it shall be the duty of the Official Liquidator to appear on the hearing of the application and call the attention of the Court to any matters which appear to the Official Liquidator to be relevant.

(*b*) If the Court, after hearing any evidence given or witnesses called by the Official Liquidator, grants the application, the Court may allow the applicant such costs as it may think fit.

(*8*) Notes of the examination shall be taken down in writing, and shall be read over to or by, and signed by, the person examined ; and may thereafter be used in evidence against him, and shall be open to the inspection of any creditor or contributory at all reasonable times.

(*9*) The Court may, if it thinks fit, adjourn the examination from time to time.

(*10*) An examination under this section may, if the Court so directs and subject to any rules made in this behalf, be held

before any District Judge, or before any *officer* of the High Court, being an Official Referee, Master, Registrar or Deputy Registrar.

(*11*) The powers of the Court under this section as to the conduct of the examination, but not as to costs, may be exercised by the Judge or *officer* before whom the examination is held in pursuance of sub-section (*10*).

Penalty for falsification of books

539. If with intent to defraud or deceive any person, any *officer* or contributory of a company which is being wound up—

(*a*) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities ; or

(*b*) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company ;

he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to fine.

Power of Court to assess damages against delinquent directors, etc.

543. (*1*) If in the course of winding up a company, it appears that any person who has taken part in the promotion or formation of the company, or any past or present director, managing agent, secretaries and treasurers, manager, liquidator or *officer* of the company—

(*a*) has misapplied, or retained, or become liable or accountable for, any money or property of the company ; or

(*b*) has been guilty of any misfeasance or breach of trust in relation to the company ;

the Court may, on the application of the Official Liquidator, of the liquidator, or of any creditor or contributory, made within the time specified in that behalf in sub-section (2), examine into the conduct of the person, director, managing agent, secretaries and treasurers, manager, liquidator or *officer* afore-

said, and compel him to repay or restore the money or property or any part thereof respectively, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Court thinks just.

(*2*) An application under sub-section (*1*) shall be made within five years from the date of the order for winding up, or of the first appointment of the liquidator in the winding up, or of the misapplication, retainer, misfeasance or breach of trust, as the case may be, whichever is longer.

(*3*) This section shall apply notwithstanding that the matter is one for which the person concerned may be criminally liable.

Prosecution of delinquent officers and members of company

545. (*1*) If it appears to the Court in the course of a winding up by, or subject to the supervision of, the Court, that any past or present *officer*, or any member, of the company has been guilty of any offence in relation to the company, the Court may, either on the application of any person interested in the winding up or of its own motion direct the liquidator either himself to prosecute the offender or to refer the matter to the Registrar.

(*2*) If it appears to the liquidator in the course of a voluntary winding up that any past or present *officer*, or any member, of the company has been guilty of any offence in relation to the company, he shall forthwith report the matter to the Registrar and shall furnish to him such information and give to him such access to and facilities for inspecting and taking copies of any books and papers, being information or books and papers in the possession or under the control of the liquidator and relating to the matter in question, as the Registrar may require.

(*3*) Where any report is made under sub-section (*2*) to the Registrar, he may, if he thinks fit, refer the matter to the Central Government for further inquiry.

The Central Government shall thereupon investigate the matter and may, if it thinks it expedient, apply to the Court for an order conferring on any person designated by the Central Government for the purpose, with respect to the company concerned, all such powers of investigating the affairs of the company as are provided by this Act in the case of a winding up by the Court.

(*4*) If on any report to the Registrar under sub-section (2), it appears to him that the case is not one in which proceedings ought to be taken by him, he shall inform the liquidator accordingly, and thereupon, subject to the previous sanction of the Court, the liquidator may himself take proceedings against the offender.

(*5*) If it appears to the Court in the course of a voluntary winding up that any past or present *officer*, or any member, of the company has been guilty as aforesaid, and that no report with respect to the matter has been made by the liquidator to the Registrar under subsection (2), the Court may, on the application of any person interested in the winding up or of its own motion, direct the liquidator to make such a report, and on a report being made accordingly, the provisions of this section shall have effect as though the report had been made in pursuance of the provisions of sub-section (2).

(*6*) If, where any matter is reported or referred to the Registrar under this section, he considers that the case is one in which a prosecution ought to be instituted, he shall report the matter to the Central Government ; and that Government may, after taking such legal advice as it thinks fit, direct the Registrar to institute proceedings :

Provided that no report shall be made by the Registrar under this sub-section without first giving the accused person an opportunity of making a statement in writing to the Registrar and of being heard thereon.

(*7*) When any proceedings are instituted under this section, it shall be the duty of the liquidator and of every *officer* and agent of the company past and present (other than the defendant in the proceedings) to give all assistance in connection with the prosecution which he is reasonably able to give.

For the purposes of this sub-section, the expression "agent", in relation to a company, shall be deemed to include any banker or legal adviser of the company and any person employed by the company as auditor.

(*8*) If any person fails or neglects to give assistance in the manner required by sub-section (7), the Court may, on the application of the Registrar, direct that person to comply with the requirements of that sub-section.

(*9*) Where any such application is made with respect to a liquidator, the Court may, unless it appears that the failure or neglect was due to the liquidator not having in his hands sufficient assets of the company to enable him so to do, direct that the costs of the application shall be borne by the liquidator personally.

Offence against Act to be cognizable only on complaint by Registrar, shareholder or Government

621. (*1*) No court shall take cognizance of any offence against this Act (other than an offence with respect to which proceedings are instituted under section 545), which is alleged to have been committed by any company or any *officer* thereof, except on the complaint in writing of the Registrar, or of a shareholder of the company, or of a person authorised by the Central Government in that behalf :

Provided that nothing in this sub-section shall apply to a prosecution by a company of any of its officers.

[1][(*1A*) Notwithstanding anything contained in the Code of Criminal Procedure, 1898, where the complainant under sub-section (*1*) is the Registrar or a person authorised by the Central Government, the personal attendance of the complainant before the Court trying the offence shall not be necessary unless the Court for reasons to be recorded in writing requires his personal attendance at the trial.]

(*2*) Sub-section (*1*) shall not apply to any action taken by the liquidator of a company in respect of any offence alleged to have been committed in respect of any of the matters included in Part VII (sections 425 to 560) or in any other provision of this Act relating to the winding up of companies.

[1] Ins. by Act 65 of 1960, s. 202.

(*3*) A liquidator of a company shall not be deemed to be an *officer* of the company, within the meaning of sub-section (*1*).

Payment of compensation in cases of frivolous or vexatious prosecution

625. (*1*) In respect of any case instituted upon the complaint of a shareholder against the company or any *officer* thereof in pursuance of section 621, the provisions of section 250 of the Code of Criminal procedure, 1898, shall not apply; and the following provisions shall apply instead.

(*2*) If the Magistrate by whom any such case is heard discharges or acquits all or any of the accused, and is of opinion that the accusation against them or any of them was false and either frivolous or vexatious, the Magistrate may, by his order of discharge or acquittal, if the shareholder upon whose complaint the accusation was made is present, call upon him forthwith to show cause why he should not pay compensation to such accused, or to each or any of such accused when there is more than one, or if such shareholder is not present, direct the issue of a summons to him to appear and show cause as aforesaid.

(*3*) The Magistrate shall record and consider any cause which such shareholder may show; and if the Magistrate is satisfied that the accusation was false and either frivolous or vexatious, he may, for reasons to be recorded, direct that compensation to such amount as he may determine be paid by such shareholder to the accused or to each or any of them, not exceeding one thousand rupees in all.

(*4*) The Magistrate may, by the order directing payment of the compensation under sub-section (3), further order that, in default of payment, the shareholder ordered to pay such compensation shall suffer simple imprisonment for a term not exceeding two months.

(*5*) When any person is imprisoned under sub-section (4), the provisions of sections 68 and 69 of the Indian Penal Code shall, so far as may be, apply.

(*6*) No person who has been directed to pay compensation under this section shall, by reason of such order, be exempted

from any civil or criminal liability in respect of the complaint made by him :

Provided that any amount paid to an accused person under this section shall be taken into account in awarding compensation to such person in any subsequent civil suit relating to the same matter

(*7*) A complainant who has been ordered to pay compensation under sub-section (3) by a Magistrate may appeal from the order, in so far as it relates to the payment of compensation, as if such complainant had been convicted on a trial held by such Magistrate

(*8*) Where an order for payment of compensation to an accused person is made, the compensation shall not be paid to him before the period allowed for the presentation of the appeal under sub-section (7) has elapsed ; or, if an appeal is presented, before the appeal has been decided

Penalty for false statements

628. If in any return, report, certificate, balance sheet, prospectus, statement or other document required by or for the purposes of any of the provisions of this Act, any person makes a statement—

(*a*) which is false in any material particular, knowing it to be false ; or

(*b*) which omits any material fact knowing it to be material ;

he shall, save as otherwise expressly provided in this Act, be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine

Power of Court to grant relief in certain cases.

633. (*1*) If in any proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an *officer* of a company, it appears to the Court hearing the case that he is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and that having

regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the Court may relieve him, either wholly or partly, from his liability on such terms as it may think fit.

[1][Provided that in a criminal proceeding under this sub-section, the Court shall have no power to grant relief from any civil liability which may attach to an *officer* in respect of such negligence, default, breach of duty, misfeasance or breach of trust.]

[2][(*2*) Where any such *officer* has reason to apprehend that any proceeding will or might be brought against him in respect of any negligence, default, breach of duty, misfeasance or breach of trust, he may apply to the High Court for relief and the High Court on such application shall have the same power to relieve him as it would have had if it had been a Court before which a proceeding against that *officer* for negligence, default, breach of duty, misfeasance or breach of trust had been brought under sub-section (*1*).

(*3*) No Court shall grant any relief to any *officer* under sub-section (*1*) or sub-section (*2*) unless it has, by notice served in the manner specified by it, required the Registrar and such other person, if any, as it thinks necessary, to show cause why such relief should not be granted.]

QUESTIONS ON CHAPTER XIV

1. What is meant by Audit Case Laws ? Examine the importance and weight of such laws.

[*Hints* : Case Laws are the laws, laid down by the decisions of the Courts with regard to some particular facts and figures. Of these, those which are closely connected with Audit are termed as Audit case Laws. The Audit Case Laws *guide* an Auditor as regards his rights, duties and liabilities, his position and his moral obligations. These Case Laws which are supposed to guide an Auditor should never be considered to be absolute ; regard must be had to every particular situation.]

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[1] Ins. by Act 65 of 1960, s. 206.

[2] Subs. by s. 206, *ibid.*, for sub-section (2).

2. "An Auditor is a watch-dog and not a bloodhound."—Discuss the statement. (B. Com.)

[*Hints* : The statement under quotation was a remark from the learned Judge, Lopes L. J., in the celebrated case of *Kingston Cotton Mill Co. Ltd.,* when he examined the question of an Auditor's duty and liability in the matter of *valuation and verification of 'Stock-in-trade'*. The Auditor may rely on the tried servants of the Management regarding such valuations and verifications, *provided he takes reasonable care*. He must always protect the interests of the shareholders ; but where he has no reason to be suspicious, he should not unnecessarily assume that mischief has been made by somebody. The Auditor must not be made liable for not tracking out ingenious and carefully laid schemes of fraud.]

3. How far, if at all, has the position of an Auditor as laid down in the "Kingston Cotton Mill Co., Ltd." and "The London and General Bank" cases been affected by the judgement in the "City Equitable Fire Insurance Co., Ltd." case ?

(B. Com.)

[*Hints* : Please refer to the facts and judgement of the cases as discussed in the book earlier. All the three cases deal with the question of the liabilities of an Auditor for non-detection of frauds and defalcations. In the *Kingston Cotton Mills case* the Auditor was relieved of assessing the Stock-in-trade personally. It was held that the Auditor was entitled to accept a certificate from the tried officials of a concern, provided scope for suspicion was absent. In the *London and General Bank case,* on the other hand, it was indicated that the Auditor should not only check the accuracy of the Accounts but should also satisfy himself whether the Books of Accounts showed a true position. It is, therefore, evident that the two decisions are conflicting in nature ; for, in one case the Auditor was freed from liability, while in the other he was found liable. *The City Equitable Fire Insurance Co. Ltd. case* has, of course, imposed greater burden on the Auditor. The position of an Auditor as laid down in the Kingston Cotton Mills and the London and General Bank cases has not been so noticeably affected since after the publication of the City Equitable Fire Insurance case decision, as the judges in each of the above cases advanced cogent reasonings in giving their verdict. An Auditor would, however, find a pointed and specific direction from the

judgement of the Fire Insurance Co. case, while prior to that he had to labour under a vagueness as to the exact scope of his duty, the earlier two case decisions being conflicting and, to some extent, vague.]

4. What do you understand by window-dressing of a Balance Sheet? Give two examples. What is the liability of an Auditor in this matter? (B. Com.)

[*Hints* : In popular parlance, "window-dressing" means the art of making the most of one's wares or merits. In the realm of Accountancy and Auditing, the term, however, has a different meaning. There it means the act of making the Balance Sheet show a better picture of the state of affairs of a concern than what the actual position warrants. So "window-dressing", naturally, is tantamount to fraud. An Auditor will be held guilty when he fails to detect such "window-dressing" as may easily be detected by a little vigilance. (Refer to Davar & Sons, Ltd. *v.* M. S. Krishnaswami case.) But a well-planned "window-dressing" which is difficult to detect by the exercise of ordinary care and industry does not make an Auditor liable. (Refer to City Equitable Fire Insurance Co. Ltd. case.)]

5. "Information and means of information are by no means equivalent terms.....An Auditor who gives shareholders means of information, instead of information, does so at his peril."

Explain the above by giving concrete examples.

(B. Com.)

[*Hints* : While pronouncing judgement in the *London and General Bank case*, Lord Lindley made his remark in the way quoted above. The Auditor in the case, in spite of being fully aware of the fact that the Loans and Advances granted by the Bank to its constituents were not reasonably secured and that the Provision for Doubtful Debts was utterly inadequate, qualified his Report to the shareholders by merely adding that "the value of the Assets as shown by the Balance Sheet is dependent upon realisation." Now, such a statement would naturally bewilder the shareholders and others connected with the Bank, and its business. A conscientious Auditor should always be true to his moral obligation and must not rest contented by merely giving what the learned Judge called "means of information". He is expected to give actual facts and figures, i.e., the information in full detail. Else, he would always run the risk of being held liable for damages.]

6. To help him in the preparation and Audit of the Accounts of a Limited Company engaged in road construction work, the company's Auditor employed an Articled Clerk who had passed the final examination of the Institute of Chartered Accountants of India. The Auditor certified the Balance Sheets in complete reliance on the work done by the Articled Clerk. The Directors and the Secretary of the company signed the Balance Sheets by completely relying upon the Auditor's work.

In the Balance Sheets as at December 31. 1950 and 1951, Profits of Rs. 56,000 and Rs 63,000 respectively were shown on a Paid-up Capital of Rs. 20 000, and large dividends had been declared. On account of financial difficulties the company went into compulsory liquidation in 1952. The Liquidator, on a scrutiny of the Accounts, came to the conclusion that there was no wilful dishonesty on the part of the Auditor, the Directors or the Secretary of the company, but that in the Balance Sheets of both the years, the 'work in progress' was valued on items of work, some of which had not been carried out in the respective years concerned. Also some liability invoices sent in by creditors had not been taken into account as the Bills Payable Book had not been properly written up to date, but there was ample other evidence to suggest the existence of such invoices.

If the facts now revealed had been properly considered and assessed, the Profits for 1950 and 1951 would have been only Rs. 150 and Rs. 175. In the above circumstances, does any liability attach to the (a) Auditor, (b) Directors or (c) Secretary? Give complete reasons for your answer. (B. Com.)

[*Hints*: The Auditor, on signing the Report on the Balance Sheet, assumes full responsibility of his job. And the responsibility does not stand properly discharged when the Balance Sheet does not reflect the true picture of the profit position. Though in this case 'wilful dishonesty' is absent (as observed by the Liquidator of the company), yet it cannot be denied that a close inspection of the Bills Payable Book and a careful check on the 'work-in-progress' valuation would have enabled the Auditor to detect the glaring inflation in the volume of profits. Here, evidently, the Auditor did none of such things, either himself or through his Audit Clerk, and as such he has to be found guilty of misfeasance. The Directors and the Secretary, however, may escape legal consequences, for the reason that they have nothing to do in the matter of preparing the Balance Sheet. Nevertheless, it would always be expected of them that they would exercise a strict vigilance on how the matters went on in the concern under their management.]

The facts of the case cited in the question are analogous to those of the well-known English case *in re* Westminster Road Construction Co., Ltd. which has been discussed in detail under Chapter XIV.]

7. An employee of a limited liability company has misappropriated funds of the company. How would the Auditor's liability be affected in consequence of :—

(i) The Directors' contributory negligence ;

(ii) Written instructions from the Board of Directors to the Auditor to carry out only a partial Audit ;

(iii) A provision in the company's Articles of Association that the Auditor is to be held indemnified by the company in all cases except that of his own lawful negligence ? (B. Com.)

[*Hints* : (i) An Auditor is the Agent of the shareholders in a limited liability company. So, he has to take every reasonable care to detect fraud, no matter who is involved in the same. The Auditor's liability is not lessened simply on the ground that the Directors were negligent. As regards (ii) and (iii), it should be noted that the rights, duties and liabilities of an Auditor of a limited liability company are clearly defined in the Companies Act. So such written instructions from the Directors and the peculiar provisions of the Articles are *ultra vires.*]

8. Discuss the principle involved in the case Lee *v.* Neuchatel Asphalte Co., Ltd. and criticise the judgement from the point of view of commercial expediency. (B. Com.)

[*Hints* : Neuchatel Asphalte Co., Ltd. was formed to acquire and work a mine under lease. The Articles of Association of the above named company provided that the Directors would not be under any compulsion to reserve moneys for renewing or replacing any lease. Though considerable amounts were written off from year to year, in a particular year no depreciation of the company's property had been provided for. And this non-provision of depreciation was objected to by one Mr. Lee, who brought action against the Directors. The decision of the Court was in favour of the Directors. A glimpse of the principle involved in the case under study can be had from the following observations of the learned Judge : "....If a company is formed to acquire or work property of a wasting nature, e.g., a mine, quarry or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company

retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided among the shareholders....."

It should be understood that when dividend is paid, depreciation on the Assets of the company not having been charged against the profits, such payment would indicate slow and gradual repayment of capital. And this sort of arrangement should be welcomed as it does not allow large funds to remain in the hands of the Directors who may not utilise them for purposes bonafide. From the point of view of commercial expediency non-charging of depreciation should be allowed only where an Asset, such as a leasehold mine, is not to be renewed after the expiry of the lease period. But if renewal or replacement is to be done, depreciation must be provided for before dividend payment and moneys set apart for being available when funds would be required for renewing or replacing the Asset. Under sec. 205 of the present Companies Act, provision for depreciation must have been made before dividend declaration could be called regular.]

9. State the case of Wilmer *versus* McNamara and Co., Ltd. and comment on the judgement delivered by Stirling J.

Can the Shareholders refuse to pass or can they reduce or increase the rate of any dividend recommended by the Board of Directors ? (B. Com.)

[*Hints* : The shareholders of McNamara and Co., Ltd. objected to the declaration of dividend, out of profits of the current year, on the ground that depreciation was not provided on the fixed assets. The Judge, however, favoured payment of such dividend. With commercial expediency in view, the judgement cannot be appreciated, since depreciation on fixed assets is always a trading loss, and has, therefore, to be provided for prior to declaration of any dividend. Under the present Company Law, making adequate depreciation on all assets should invariably be insisted upon before any dividend would be paid.

Shareholders can reduce, or even refuse to pass, the proposed dividend. of the business. The Companies Act, however, does not empower the shareholders to increase the rate of dividend as recommended by the Board.]

10. The Auditor of a Private Limited Company, all the three shareholders of which are its Directors, gives a full report to the Board of Directors but does not give similar information in his report to the shareholders. What, if any, is his liability in the matter ? (M. Com.)

[*Hints* : If the Auditor of a Private Limited Company reports to the Directors, who are also the only shareholders of the company, about the imperfection in the maintenance of the Account Books, he is not liable for damages on the ground of negligence of duty. In the case *Pendleburys Ltd.* v. *Ellis Green & Co.* the Auditor reported to the Directors of this Private Limited Company that they were unable to conduct an exhaustive Audit due to the defects in the accounting method. The Directors took no action in the matter. Subsequently defalcation of cash was perpetrated, and the Directors brought a suit against the Auditor, claiming damages. It was held by the Court that the Auditors were not liable because they had duly reported about the loopholes in the accounting system to the Directors of the company who, in this case, were the sole shareholders.]

11. Discuss the question of liabilities of an Auditor if it were subsequently discovered that the accounts that were certified by him contained false and fraudulent entries. (M. Com.)

[*Hints* : If the Auditor certifies a Balance Sheet compiled from Account Books that contain false or fraudulent entries, he will be liable for misfeasance. In the *Union Bank of Allahabad Ltd. case* the Bank went into liquidation due to heavy losses. It was discovered that enormous advances had been made to fictitious persons by the Manager. Besides, large sums of loans had been granted to men who never existed. These Loans and Advances were described in the Balance Sheet as fully secured. So it is out of *false* profits that the dividends were paid. The Directors and the Auditor were prosecuted for damages due to misfeasance. And the Court found all of the defendants guilty.]

CHAPTER XV

INVESTIGATIONS

Investigation means making inquiry into a certain matter. A person may be appointed to conduct a thorough inquiry into an affair for some *special* purpose and submit his report thereon. The report would be called Investigation Report. An Auditor will be concerned with such investigations only as imply scrutiny of the Accounts of a business or of a non-trading institution, held for a particular purpose.

Meaning & Scope of the term *Investigation*

The difference between the role of an *Investigator* and that of an *Auditor* should be carefully observed. The former tries to get a particular information for his client, whereas the latter certifies whether the Accounts have been properly drawn up and whether the Balance Sheet exhibits the correct position of the concern under Audit. An Auditor has to deal with the Account Books together with supporting vouchers and documents. An Investigator may be concerned with these or with affairs not coming to Auditor's concern. An Auditor checks up the Accounts for a half-year or for a year, but the subject-matter under investigation may relate to a number of years or to a fraction of a year. An Auditor is appointed by the Management of a business concern or of a non-trading organisation, an Investigator, on the other hand, may be appointed either by the Management of, or by a person interested in, an institution—trading or non-trading. The Investigator in many cases works on the basis of Books of Accounts already audited upon. Sometimes the Accounts, on which the Auditor has completed his work, are made to undergo certain adjustments for meeting the purpose of investigation.

Difference and Relation between 'Investigation' and 'Audit'

Usually the investigation work is entrusted to a Professional Accountant. Before commencing investigation he should first

inquire into the object for which it is arranged and get from his client clear-cut instructions regarding the exact scope of his work. He should then acquaint himself with the nature of business, the financial books maintained and the 'internal check' in operation. The next business should be to draw up the *Investigation Programme.* The audited Accounts together with the Auditor's Report will have to be carefully examined, preferably for the past three years. To what extent the Auditor qualified his Report and the reasons for the qualification should engage the particular attention of the Investigator.

After the probe is complete, the Investigation Report will be prepared for submission to the client, in words free from ambiguity. The Report should include all the important aspects of the Investigator's findings.

DIFFERENT CLASSES OF INVESTIGATION

Investigation on behalf of a party wishing to purchase a runing business. The Investigator should, at the very outset, see whether the Accounts had already been subjected to an Audit. In the cases of a satisfactory Audit being in operation, he will redraft the Trading and Profit and Loss Account and the Balance Sheet in columnar form for the last three years. The trading results should be ascertained on a uniform basis for the sake of comparison. A special column should be inserted for indicating percentage of expenditure to sales. If there is a marked variation between the results of one year and those of another, the Investigator should take particular note of the matter and inquire in detail to clarify the situation. Another column should be set up for percentage of Gross Profit to Sales. And if there is any variation here, the causes should be investigated into. It should be noted here that a trading concern having dealings with the Public Sector (the Government or Government-subsidised institutions) will have less marginal profit than those having dealings with the Private Sector (Non-Governmental undertakings). While investigating into the cause of fluctuations in the percentage of Gross Profit to Turnover, the Investigator should bear this point in mind. The Purchases Book, especially the entries of the last month, should be scrutinised with the original invoices with a view to seeing

whether any Purchases have been suppressed resulting in the reduction of Liabilities and an increase in the volume of Gross Profit. The Goods Inward Book should also be checked up to see whether any goods received within the financial period are excluded from the Stock at close. The payment vouchers of at least three months beyond the financial period should also be seen to guard against suppression of Liabilities. Similarly, the Sales Book should be brought under a scrutiny, particularly for the last month of the financial year. This would bring manipulation of Sales figure, if any, to light. The entries in the Sales Book of the sales done during the last month should be verified with copies of Outward Challans and Goods Outward Book. The taking of Stock and its valuation should be tested with the Stock Book and other relative records

After satisfying himself regarding correctness of the Gross Profit for the past three years, the Investigator will now analyse the columnar Profit and Loss Account compiled by him for the preceding three years. While doing so, he should pay particular attention to the percentage of various expenses to turnover and inquire into variations, if any. It should also be seen whether proper provision has been made for Depreciation in compliance with the terms of the Income Tax Act. Whether due provisions have been made for taxation liabilities and for Bad and Doubtful Debts has also to be carefully checked up.

When satisfied as to the genuineness of the Profits (*Gross* as well as *Net*), the Investigator's next task shall be to scan the Balance Sheet drawn up in columnar form, showing Assets and Liabilities at the end of each of the three preceding years. The Investigator should pay particular attention to the valuation of the Assets as shown on the face of the Balance Sheet, bearing in mind the directions given in the Statute in respect of the valuation of Assets. If there is any *Goodwill*, the method and basis (discussed in Chapter VIII) of arriving at the value should be scrutinized by the Investigator. Lists of Sundry Debtors and Sundry Creditors as per the last Balance Sheet are to be verified from respective ledgers and got confirmed from the parties concerned. The Investigator will hereafter examine all

the liabilities and Loans incurred and satisfy himself that the figures are correct.

The ascertainment of the intrinsic value of the Business is also to engage proper attention of the Investigator. This valuation may be made (i) on Net Assets basis (Assets *minus* Liabilities) or, (ii) on the Net Average Profits basis, average being taken of Profits of the last five years or, (iii) on the yield basis, the rate of return obtained from the Capital employed in the business being taken into account.

Having completed the investigation work on the lines indicated above, the Investigator will now draw up his Report, bearing in mind the requirements of his client. This Report should be written in a clear and precise manner giving indications of the findings obtained during the course of investigation. Under no circumstances, should the Investigator give vent to any opinion regarding advisability or otherwise of the Purchase of the Business. His Report should only contain statements of facts and the period covered by his investigation. This will help the client to form their own opinion and arrive at a decision.

Investigation on behalf of a client desirous of becoming a Partner in a going Firm. The Investigator should obtain a copy of the Partnership Agreement and study the terms and conditions embodied therein. He should inquire into the considerations behind the taking in of a new Partner. His Investigation programme will be on the lines as suggested for an Investigator appointed on behalf of an intending Purchaser of a running Business. While conducting the probe, if the Investigator finds that the partnership business is in financial difficulties, the nature of financial weakness ought to be mentioned in the Investigation Report. A Firm is considered to be pecuniarily unsound when, compared to its ability to bear, it takes on its shoulder heavy liabilities. The valuation of Assets to be incorporated in the new Partnership Books should engage due attention of the Investigator. The value of Goodwill and the amount of Capital to be introduced by the newcoming ~~Partner~~ should also come to the Investigator's pointed notice. When the investigation is completed, it will be a duty of the

Investigator to submit a Report to his client giving all the information which may be of concern to him.

Investigation on behalf of a person wishing to buy Shares in a Company. The Investigator will study the Memorandum and the Articles of the Company to ascertain the objects and the system of internal management and the borrowing powers. He will then draw, as indicated before, a columnar Trading and Profit and Loss Account of the past three years and examine the trend of Gross and Net Profits The Balance Sheet items should be scrutinized fully The basis of valuation of Fixed and Current Assets should engage the attention of the Investigator. He should make inquiries to know whether there are any pending actions or claims against the Company for breach of contract. So far as the Liabilities are concerned, the investigator will see whether there are Redeemable Preference Shares or Redeemable Debentures and whether the Company has sufficient Liquid Assets to meet such liabilities. Further the Investigator should ascertain whether the Company is in a position to pay the 'Current Liabilities'. In short, it is the duty of the Investigator to embody in his Report the true and fair view of the financial condition of the Company. It will also be a duty of the Investigator to ascertain the intrinsic value of the Capital employed in Business, by determining the Share value which may be based on (i) an average of the last five years' profits or, (ii) the Net Assets or, (iii) the yield. As a guide the Investigator may find the normal yield of similar classes of business from the Stock Exchange Gazette or from leading Commercial Magazines like the *Capital* or the *Commerce*. This helps correct Valuation of Shares. After completing his work, the Investigator will write a Report giving the essence of his findings in a precise manner so that his client may arrive at a correct decision in the matter of subscribing for the Company's Shares.

Investigation for the purpose of Share Valuation. The Investigator should, at the very outset, prepare a Statement in detail of the Assets and Liabilities of the Company. Fixed Assets should be valued at original cost *less* depreciation to date and Current Assets at cost *or* realisable value, whichever is less.

If there are Secret Assets they should be included. It should be seen that proper provisions have been made for 'Depreciation' and 'Bad and Doubtful Debts'. From the total value of the Assets should be deducted the total of all the Liabilities and the amounts due to Debenture holders and Preference Share holders. In this way the value of Net Assets will be arrived at. If this figure is divided by the number of Equity Shares, the price per Share will be determined.

Another method of arriving at a correct valuation of Shares is based on last five years' average profits and on the corresponding Dividends paid to Shareholders. For example, if the nominal value of an Equity Share is Rs. 100 and if a 10% Dividend was declared on an average during the preceding five years when the normal rate of interest allowed by Bankers was 4 per cent., the Share will be valued at Rs. 250 (10/4 $\times$ Rs. 100).

A third method popularly known as Average yield basis, which takes into consideration the yield on Capital employed in other similar industries, may also be adopted for Share Valuation. For instance, the case may be that the average Dividend paid by the company under study during the past five years is 10 per cent. for Equity Shares of Rs. 100 each, whereas on Shares of same nominal value of similar industries a Dividend of 14 per cent. is paid, while the Bank offers interest at 4 per cent. The *average yield* in the above illustration will be 12 per cent. ($\frac{10+14}{2}=12$). Therefore the valuation of such Shares will be Rs. 300 per Share (Bank interest 4 per cent. $\times 3 = 12$ per cent. average yield).

In his Report, the Investigator will show all the three valuations of Shares found from the three different methods for the guidance of his client.

Investigation for Tax Purposes. The Investigator will, at the outset, obtain from his client Audited Balance Sheet and Profit & Loss Account for the past three financial years, and the Income Tax file where Demand Notices and copies of Assessments will be found. He is to see whether Provisions for Taxation as shown in the Accounts were adequate for the actual Assessment Orders, i.e., the taxation liabilities. If the

Assessments are up-to-date and Income-Tax liabilities paid up to the last financial year, the Investigator will scrutinize the items of the current Profit & Loss Account to verify whether any disallowable expenses like charities, donations and capital expenditure *or*, losses on the sale of fixed assets have been charged against the profits to minimise the assessable income. If the computation of Income Tax has been done on the basis of minimised income, the Investigator will add back to the Net Profit all the disallowable items of expenditure in order to arrive at the correct assessable income on which the Income Tax and Super Tax are to be calculated. The Investigator will then obtain a copy of the Income-Tax Act and calculate the liability for taxes in accordance with the schedule set in there. The investigation being over, a Report will be drawn out showing the Income-Tax computation and the tax liability clearly.

Investigation for a Bank which wants to give Credit to a Constituent. If the constituent is a Sole Trader, the Final Accounts should be prepared in a columnar form as discussed before and put to a thorough scrutiny for assessing the financial position of the business. It should be seen whether he is in a position to meet his existing liabilities from the liquid Assets available. The nature and the market quotations of the *Investments* hypothecated to the Bank for securing the Overdraft should draw the attention of the Investigator. As a matter of prudence, only sixty per cent. of the aggregate value of the Securities lodged with the Bank should be the limit of the Overdraft allowed to a constituent. The Investigator should inquire into the reason for taking the Overdraft and the manner of utilising the money. He should also see whether the constituent is involved in a case pending before the lawcourt for damages, claims or breach of contract. In countries of advanced commercial development there are specialised institutions called *Information Agencies* who collect information as to the worthiness for credit of parties, and sell the collected information, strict confidence being maintained. Where suitable, the Investigator may, on behalf of his client, seek help from such source. On completion of his work, the Investigator will communicate to the Bank his observations.

Investigation on behalf of a Client Suspecting a Fraud in his Organisation. It is the duty of an Auditor to detect fraud, if any, in the Accounts. Where, however, the Management of a concern has reason to believe that fraud has been perpetrated in a particular sphere, an Investigator is usually appointed. The Investigator will visit his client's place and ascertain the nature of fraud. If there is cash defalcation, he should see whether the Cashier is in charge of writing the Cash Book in addition to his normal duties. If so, the Investigator will check the Cash Book in detail and get Certificates of opening and closing Bank Balances. The Bank Pass Book and the Cash Book should be checked exhaustively and a Bank Reconciliation Statement prepared. The method of receiving Cash and Cheque and of depositing them into the Bank should be scrutinized by taking the Paying-in-slips into a thorough examination with reference to relevant entries in the Cash Book. The Receipt Books having counterfoils of the original Receipts given to parties should also be checked from the Cash Book. The Investigator will see whether the counterfoils bear all the consecutive numbers. If a number is missing, suspicion should arise in the mind of the Investigator and he should probe into the matter.

Regarding collections from Sundry Debtors, the Investigator will check in detail the Sales Book, the Bill Register and copies of Outward Challans to verify whether all collections have been duly recorded in the Books. In the case of collections from Cash Sales, the Investigator will check in detail all the copies of Cash Memos, being particular about it that no consecutive number is missing. The daily total of cash collections should be verified with the respective entries in the Cash Book. The Investigator will then check the castings and postings of the Cash Book.

As regards cash disbursements, the Investigator has to check all the payment vouchers. Whether such vouchers bear the initials of an official having authority to sanction the payment should be especially looked into.

If there has been a defalcation of goods, the procedure of investigation will take the shape as outlined for an Investigator appointed on behalf of a purchaser of a running Business, particular attention being paid to all *Purchases*, *Sales* and *Stock* records.

Where Accounts have been falsified, a thorough check of *all* the Financial Books, especially the Journal, will be necessary. Particular attention should be paid to the method of Stock valuation, existence of Secret Reserve, if any, and proper differentiation of Capital Expenditure from Revenue Expenditure.

After satisfying himself with the above operations, the Investigator will prepare his Report in a clear-cut language, indicating loopholes in the organisation that make room for fraudulent practices.

Investigation under the Companies Act. Under Section 235 of the Companies Act 1956, as amended, the Central Government may appoint one or more competent persons as *Inspectors* to investigate the affairs of any Company and to report thereon in a manner directed by the appointing authorities. Such appointment will be made by a Company having Share Capital on the application of either at least 200 Members or of Members holding not less than one-tenth of the total voting power. For Companies not having a Share Capital, one-fifth or more of the Members on the company's register would be competent to apply for investigation by an Inspector. Such investigation may also have to be conducted on a Report by the Registrar of Companies

Under section 236, an application by the Members of a company, filed in accordance with Section 235 for an investigation being held, shall be supported by such evidence as the Central Government may require for the purpose of showing that the applicants have good reason for demanding an investigation. And the Central Government may before appointing an Inspector require the applicants to give security for an amount not exceeding one thousand rupees for payment of investigation cost. Under section 237, the Central Government shall appoint one or more competent persons as Inspectors to investigate the affairs of a company and to report thereon according to direction of the Central Government if the company, by special resolution, or the Court, by order, declares that the affairs of the Company ought to be investigated by an Inspector appointed by the Central Government. Investigation may also be directed by the Central Government if there are circumstances suggesting any of the following :

(i) that the business of the Company is being conducted with intent to defraud its creditors, members or any other persons or otherwise, for a fraudulent or unlawful purpose ;

(ii) that persons concerned in the formation of the company, or in the management of its affairs, have been found guilty of fraud and misfeasance ; or,

(iii) that the Members of the company have not been given all the information with respect to its affairs which they might reasonably expect.

Under section 274, the Central Government may appoint one or more Inspectors to investigate and report on the membership of any company and other matters relating to the company for the purpose of determining the true persons who are financially interested in the success or failure of the company or who are controlling and influencing the policy of the company. Under section 248, the Central Government may investigate the ownership of any Shares or Debentures of the company or of a body corporate which acts as the Managing Agent or Secretaries and Treasurers of a company. Under section 249 where any question arises as to whether any body corporate, firm or individual is or is not an associate of the Managing Agent or of the Secretaries and Treasurers of a company, the Central Government may direct investigation in the matter.

Investigation in an Insurance Company. Under sections 33, 37 and 87 of the Insurance Act 1938, the Controller of Insurance may direct investigation himself or on the requisition of policy holders or shareholders of an Insurance Company. Such investigation is ordered if the Controller of Insurance has sufficient reason to believe that the interests of shareholders and policy holders are being jeopardised. Another case for investigation under the order of the Controller of Insurance arises when it is found that the Insurance Company is functioning contrary to the provisions of the Insurance Act or is unable to pay the current liability.

QUESTIONS ON CHAPTER XV

1. What is Investigation? Distinguish Investigation from Audit. (National Diploma in Commerce)

2. What is meant by investigation of the accounts of a business and how does it differ from an Audit? Mention some of the purposes which may necessitate investigation of accounts of a business. (B. Com.)

3. State the general duties of an Investigator.

[*Hints*: The general duties of an Investigator are the following: –

(a) To investigate into the matter as determined by the letter of appointment and submit his Report. The object and scope of the investigation will depend on the letter of appointment

(b) To take into examination all of the records and financial books that are essential for the investigation purpose.

(c) To draw up Accounts in columnar form showing the results of at least three years for a comparative study.

(d) To scrutinize the audited Accounts of at least three years to get information and to form a fair idea as to the subject-matter under investigation.

(e) In case of a fraud to see whether 'internal check' is in operation and to check up all cash transactions.

(f) To submit the Investigation Report in a clear-cut language.]

4. How would you conduct an Investigation? Lay down the procedure. (B. Com.)

5. A trusted friend of yours desires to join a firm running three stationery shops in the city. Outline a questionnaire (to be sent to the firm) on which you will seek complete satisfaction before you can give him a definite guidance in the matter. (B. Com.)

[*Hints*: The following questions may be sent :—

(1) What is the working capital employed in each of the shops?

(2) What is the valuation of Stock held at each shop?

(3) What is the volume of annual sale and annual purchase at each shop?

(4) What is the extent of Rent and Establishment Charges at each shop ?

(5) What was the Net Profit at each shop during the past three years ?

(6) What was the total amount of Assets and Liabilities at each shop on a date near the proposed date of purchase ?

(7) Were the Accounts of the preceding three years subjected to Audit ? If so, on what lines did the Audit Report go ?

(8) Is there any competition in the locality ?]

6. A Chemists' Shop in the city which is regularly attended by two eminent medical practitioners is to be joined by one of your friends in the position of a partner. What are, in your opinion, the essential points that should be fully considered before you can advise him in the matter ? Give reasons for the points to be raised by you. (B. Com.)

[*Hints* : The following points ought to be considered :—

(1) Whether the Shop is running at a Profit for the last three years.

(2) What interest is gained on the capital employed by the Shop taking into consideration the Net Profit.

(3) Whether there is any keen competition in the market in general and in the neighbouring areas.

(4) Whether the Shop depends mainly on the prescriptions served or on the sale of patent medicines.

(5) Whether the Shop has to depend on medicines imported from abroad and whether there are rigid import restrictions.

(6) Whether the Physicians employed by the Shop have good practice and reputation.

(7) The valuation of the Assets and Liabilities of the concern.

(8) The assessable income of the Shop for the last three years by reference to the Income-Tax file.]

7. The Head Office of a company, of which you are the Auditor, supplies goods to its Branch at selling price which is

cost plus 25%. During the period under review, a small fire at the Branch destroys part of the Stock. The following information is obtained from the books of accounts at the Head Office :

Goods sent to Branch	Rs.	2,00,000
Sales at Branch	„	1,80,000
Sales Returns	„	4,000
Opening Stock	„	25,000
Closing Stock	„	10,000
Goods returned by Branch to Head Office	„	20,000
Loss by pilferage	„	1,000
Salvage Receipts	„	2,000

Draw up the Branch Stock Account at the Head Office and indicate the amount to be claimed for loss by fire for which you are being paid as investigator a special fee (B Com)

[*Hints* The Branch Stock Account to be prepared at the Head Office will be *debited by* the following items : (i) Opening Stock, (ii) Goods sent to Branch, and (iii) Sales Returns, and will be credited by (i) Sales at Branch, (ii) Goods Returned by Branch to Head Office, (iii) Loss by pilferage, and (iv) Closing Stock. The excess of the debit total over the credit total would represent the Stock destroyed by fire. Adjustment of the differentiation between the cost price and the invoice price would be required. From the amount of Stock destroyed by fire has to be deducted the 'Salvage Receipts' and the difference would be the amount for which claim should be filed with the Insurer.]

8. Some shareholders of a company have submitted a petition to the local Government for appointment of an Inspector to investigate the company's affairs. What are the conditions on the fulfilment of which the Government may take action on this petition and what would in that case be the duties of the Inspector ? (B. Com.)

[*Hints* : The shareholders of a Limited Company by passing a Special Resolution may request the Central Government to appoint an Inspector under Section 237 of the Companies Act 1956 (as amended) to investigate into the affairs of the company for fraud, mismanagement and misfeasance The Inspector will then examine in detail the financial books with vouchers and other relative documents and see whether any fraud, mismanagement or misfeasance has been committed. He will examine the Contract Register containing details of all agreements, the Directors' Minute Book and the

Mortgage Register to see whether any mismanagement has been done and submit his Report to the Central Government.]

9. The Secretary of a trading company, who had complete control over the books and cash, has absconded, and the Directors instruct you to examine the accounts with a view to ascertaining whether there are any irregularities. What steps would you take to satisfy yourself on the point ?

(*Chartered Accountants*)

[*Hints* : The Investigator will examine the following :—

(a) Cash Book with Receipt counterfoils and payment vouchers in full ;

(b) Purchases Book with original invoices ;

(c) Sales Book with copies of outward challans ;

(d) Journal with vouchers ;

(e) Bill book with copies of Bills ;

(f) The previous audited Accounts ;

(g) The Directors' and the Shareholders' Minute Books ;

(h) The Application and Allotment Book and the Call Book ;

(i) The Shareholders' Register and counterfoils of Share Certificates ; and

(j) The Dividend Register and counterfoils of Dividend Warrants.

By examining the above books the Investigator will be in a position to submit his Report to the Directors regarding any fraud or irregularities perpetrated by the Secretary.]

10. You are asked to investigate the accounts of a firm on behalf of an incoming partner. Should you go behind the books presented to you ? Give detailed reasons for your answer.

(M. Com.)

[*Hints* : The Investigator will not only examine the Books and the audited Accounts, but also enquire into the circumstances that prompted the admission of a new partner. Whether the partnership business has sufficient working capital for conducting the affairs of the concern smoothly and whether there are open competitors in the market of similar business should come under investigation. The Investigator should also examine the Partnership Agreement and study the

terms contained therein. To make investigation complete, a fresh valuation of all the Assets and Liabilities of the firm must be arrived at.]

11. A prospective purchaser of a business engages your services for investigation of its affairs and for assisting him in making a final decision in the matter. Indicate the essential points on which suitable enquiries will be made by you and incorporate your findings in the form of a report addressed to the party. (M. Com.)

[*Hints* : The Investigator will concentrate on the following points :

(a) The trend of Gross Profits and Net Profits of the past three years.

(b) The trend of expenditure in ratio to sales, of the past three years.

(c) The competition from sister institutions.

(d) The capital employed in the business during the past three years and the rate of its return.

(e) Income-Tax paid during the last three years.

(f) The valuation of the Assets & Liabilities of the business.

(g) The reason for the sale of the business.

(h) The Audited Accounts of the past three years.

(i) Whether the business has Goodwill and reputation in the Market and the factors that are preeminently responsible for it.

After examining into the above matters the Investigator will submit his Report embodying all the facts arrived at during his investigation.]

12. State what matters would receive your attention in considering the accounts of a limited Company if you were acting on behalf of :—

(a) a prospective creditor, (b) a prospective shareholder. (M. Com.)

[*Hints* : (a) On behalf of a *prospective creditor* the Investigator will see the following :—

(i) The Agreement with the Managing Agents showing the terms under which they would be paid their Remuneration and the actual Remuneration paid.

(ii) The Memorandum and the Articles of Association of the Company (to see whether terms embodied therein are complied with).

(iii) The Agreement with the Directors showing the rates at which they would be paid their Remuneration and the actual Remuneration paid.

(iv) Contracts entered into by the company to see the Liabilities of the Company and whether they have been provided for in the Accounts.

(v) The Audited Accounts of the previous years (to see the trend of Profits and Expenses).

(vi) The Bank balance and the Cash in hand (to see whether they are sufficient to pay up the Creditors).

(vii) The valuation of Assets and Liabilities and the working capital employed in business.

(viii) The total figure under 'Current Liabilities and Provisions' in comparison to that under 'Current Assets, Loans and Advances'.

(ix) Comparative figures of Purchases and of Sales.

(b) On behalf of *a prospective shareholder* the Investigator will see the following :

(i) The Authorised and Subscribed Capital of the company.

(ii) The Dividends paid during the last five years.
(iii) The Annual yield on the Capital employed.
(iv) The trend of Purchases and Sales.
(v) The ratio of Expenditure to Sales.
(vi) The average profits of the last five years.
(vii) The Reserves created by the company out of Appropriation of Profits.

(viii) The Liabilities & Assets of the company as they appeared on the last Audited Balance Sheet.

(ix) Investments and Securities of the company.
(x) The Bank and Cash Balances.
(xi) The market price of the Shares of the company.]

13. The Directors of a mill company suspect the honesty of their General Manager and you are asked to carry out an investigation of the last three years' accounts of the company. Draft the report you will submit after the completion of your work. (M. Com.)

[*Hints* : The Investigator will submit his Report in a clear and concise manner to the Directors of the company after conducting his investigation in the following manner :—

(a) Draw up in a Columnar Form the Profit & Loss Account and the Balance Sheet for the past three years.

(b) See the percentage of Gross and Net profits to Turnover and compare the expenses of three years.

(c) Examine the Cash Book with Cash receipt counterfoils and with payment vouchers in detail, and see that all receipts are banked on the very day the money is received or on the following day through Paying-in-slips.

(d) Check the Wages Abstract and the Muster Rolls and other necessary records related to wage payment.

(e) Check up the Unpaid Wages Book in detail by reference to supporting documents and see that no money is misappropriated.

(f) Check the Purchases and Sales Books with relative Records.

A specimen Draft of the Investigation Report to be submitted to the Directors of the mill company.

Dear Sirs,

On an investigation of the books and records and the Accounts of your company for the three years ended 31. 12. 59, 31. 12. 60 and 31. 12. 61, we make the following observations.

(a) Considerable amounts were misappropriated by the General Manager in collusion with the Works Manager through Muster Rolls by making fictitious wage payments appear over there. This fact was revealed by means of a comparison between the Attendance Registers of the different departments of the mill and the Muster Rolls. It appeared that during the three years under investigation, on an average, thirty ghost workers were shown as receiving emoluments. The defalcated amount was nearly Rs. 6,000 a month.

(b) On an examination of the original invoices relating to purchases of raw materials, it was found that consistently during all of the years under review,

orders were placed with the suppliers by the General Manager to make purchases at rates five per cent. higher than market rates. The total amount involved is calculated at Rs. 75,000 nearly.

Yours faithfully,
Banerjee & Co]

14. The Cashier of a firm, who also acts as Accountant-Book-Keeper, has been suspected of dishonesty. The Books have not been audited, and you are asked to investigate. State briefly how you would proceed.

[*Hints* . The Investigator will proceed on the following lines .—

(a) Enquire into the method of receiving money and making disbursements.

(b) Enquire of whether money received is paid into the Bank daily and whether payments are made by A/C. Payee Crossed Cheques only.

(c) Check the record of the receipts by reference to Receipt counterfoils.

(d) Check the record of all payments with the Counterfoils in the Cheque Book, payment vouchers and the Receipts from parties

(e) Check the Cash Book with counterfoils of the pay in slips and with Bank Statements.

(f) Prepare a Bank Reconciliation Statement from the Cash Book and the Bank Statements and obtain a certificate from the Agent of the Bank regarding Bank Balance.]

15. The Articles of Association of a private limited company provide that the value of the Shares for the purpose of transfer shall be fixed by the Auditor. It has become necessary for the valuation of Ordinary Shares to be made, and you are called upon to do this.

What information would you require to enable you to comply with the request and to what matters would you give attention ? (B. Com.)

[*Hints* : The following information will be required :—

(a) The Audited Accounts of the Company to ascertain the Net Asset value of the Shares. The value of Assets less the value of Liabilities in the Balance

Sheet will indicate the Net Asset value. If this value is divided by the number of Equity Shares, the value per share will be arrived at.

(b) The Market Price of the Shares as quoted in the Stock Exchange.

(c) The amount of Dividends paid during the last three years.

(d) The nature of business transacted by the company.

The Investigator will give particular attention to the following :—

(a) The object clause of the Memorandum and the clauses relating to internal management of the company as per Articles of Association

(b) Valuation of Assets & Liabilities and the working capital.

(c) Whether this is a monopoly business.

(d) What Dividends are paid by similar industries.]

16 Your client is contemplating joining an established firm of Surveyors as a partner. He has given you an introduction to the firm and has handed to you a draft of the proposed terms. He has instructed you to make such an investigation of the affairs of the business as you think fit and to advise him generally.

State the matters to which you would direct attention when carrying out your investigations.

(Chartered Accountants)

[*Hints* : The following matters will receive the Investigator's attention :

(a) The reason for admitting a new partner.

(b) A comparative study of the Profit & Loss Account and the Balance Sheet of past three years prepared in a columnar form

(c) The trend of Profits in comparison to services rendered.

(d) The reputation of the existing firm of Surveyors.

(e) Whether this is a monopoly business.

(f) The value of Assets and Liabilities.

(g) The net income of the past three years by way of survey fees.

(h) The existing Partnership Agreement.]

17. You are instructed to carry out a complete investigation of 'Salaries and Wages'. Draft the programme of your investigation. (*Chartered Accountants*)

[*Hints* : The following books and documents should be taken into special examination :—

(a) Salary Book having deduction columns for Provident fund, Income-Tax, Advances, etc.

(b) Employees' stamped Receipts on the body of the Salary Book at the time of payments.

(c) Service Agreements between the employees and the employer.

(d) Unpaid Salary Book (to see whether all outstandings have since been paid and receipted).

(e) The Wages Book with workers' Punched Cards. Wages Abstracts and Piece Rated Cards

(f) The Muster Roll with Gateman's Attendance Register and Punched Cards

(g) Shop Attendance Register with the Muster-Roll

(h) Piece rated cards with Foreman's Records and Job Cards.

(i) A certificate from the Works Manager that wage payments were made in his presence

(j) All castings and calculations in the Wages Book and the Muster-Roll.]

CHAPTER XVI

DIFFERENT CLASSES OF AUDIT

1. **Club Audit.** The Auditor should read carefully the Rules and Regulations of the club and ascertain if any internal check is in operation and the extent of that check. The Cash Book is the main financial book in the club and it must be seen who is entrusted with the task of recording the receipts and disbursements of cash and who is authorised to pass the payment vouchers. The Cash Book should be carefully vouched. All the bank transactions should be checked with the Bank Statement and a Bank Reconciliation Statement is to be prepared on the financial closing date and a certificate from the Agent of the Bank must be obtained certifying the closing balance. All the subscriptions, donations and admission fees must be verified with the Receipt Book counterfoils of the club. The Receipt Book must be consecutively numbered and it must be seen that there is no missing number. Income from investments must be checked and all the Securities personally inspected by the Auditor. The total of Subscriptions realised from the members must be found agreed with the list of members of the club. Receipts from Billiard Room, Dining Room, etc., must be checked with the Steward's Receipt counterfoils and monthly Statement of Accounts. The Beer, Wine and Cigarette Stock certificate must be obtained from the Secretary of the Club and verified with the Stock Book. The Purchases Book must be checked with the original invoices. The wage payments should be verified by reference to the Wages Book. The minutes of the Club meetings must be seen in the Minute Book. An Income and Expenditure Account must be prepared and signed by the Secretary of the Club on the closing date. This Account must be carefully checked by the Auditor to see that all accrued incomes and outstanding expenses have been brought into the Account.

2. **Audit of a Co-operative Society.** The Auditor should read carefully all the Regulations of the Society and enquire into the 'internal checking' system. He should then take the

Cash Book into careful examination and vouch all receipts and payments. The closing Cash Balance and Bank Balance must be verified by him. A certificate from the Bankers must be obtained for the closing bank balance and a Bank Reconciliation Statement prepared to agree with this closing balance. The Sale Returns from different co-operative shops must be vouched carefully. The Auditor must check the payment of dividends and their calculations. The Investments should be examined personally by the Auditor. The forms of Accounts and the Auditors' Report must be in terms of the requirements of the Co-operative Societies Act and the regulations framed by the Society which must be studied carefully by the Auditor. The Loan Payments must be vouched with Members' Receipts and the Loan Ledger. The sanction behind the granting of a Loan should be vouched by reference to the Minute Book.

3. **Audit of an Electric Supply Company.** The Cash Book should be vouched fully. A Bank Reconciliation must be made and a certificate obtained from the Bankers. Receipts of cash should be checked with consumers' Bills and collection receipt books. The Consumers' Ledger should be checked with Meter Books for consumption. Rent for Meters and sale of any parts and Receipts from consumers should be verified from National Cash Register Till Returns. Consumers' Deposits should be checked with the Deposit Register and the Receipt counterfoils. The consumers' ledger balances must be agreed with the total of the balances of Accounts of the Impersonal Ledger. The rates charged to consumers should be test-checked, and for Government Duties, the Contracts with the Government for the supply of Public Lighting should be examined. The Purchases Day Book should be checked with the Invoices. All outstandings must be checked carefully and the Auditor should see whether there are any bad debts. The Stock Schedule should be checked with Stock Ledger or Bin Cards and both quantities and prices should be brought under a test-check, and a Certificate obtained regarding the Closing Stock from the Management which must be verified by personal inspecting. Payments of Petty Cash Book must be vouched by reference to the relevant vouchers, and Salaries and Wages should be checked carefully and fully vouched. All Capital Expenditure should be verified with

necessary documents Adequate provision for depreciation should be credited to Depreciation Fund Account. The Auditor should see that the Forms of Accounts are in terms of the relevant statute.

4. **Audit of a Manufacturing Company.** The Cash Book should be thoroughly vouched and a Bank Reconciliation made. A certificate must be obtained for the closing Bank Balance from the Bankers. The postings from the Cash Book to General and Personal Ledgers should be checked. Wage payments are to be vouched with Muster-Rolls or Wages Book. The Sales Day Book and the Purchases Day Book should be vouched with challans and invoices and the postings of these books are to be checked with the Personal Ledgers. The Total Debtors' and the Total Creditors' Accounts in the General Ledger must be agreed with the total of all the balances of the Sold and Bought Ledgers. The confirmation of these balances must be obtained from parties on the closing date If there is any *costing system* in operation the Auditors should carefully scrutinize this method and verify whether the system is a scientific one. All the Investments and Securities together with the Title Deeds of Land and Building and other properties must be inspected by the Auditor on the closing date. All Capital Expenditure must be vouched. The Production Accounts should be verified by reference to the relative Accounts maintained by the Costing Department. The Stock Schedule must be checked in detail. The method of valuation should be ascertained. The cost or market price whichever is lower must be taken. A certificate must be obtained from the management stating that Stock was physically counted, measured or weighed by the Management on the date of the Balance Sheet and that they were valued at cost or market price whichever was lower and that they belonged to the company and that proper provision has been made for depreciation of old stock. With this certificate and the Inventory List the Auditor should personally verify closing stock. He should also examine the Debenture holders' and the Shareholders' Registers. Whether proper provision, as laid down in the Income-Tax Schedule has been made for Depreciation should receive the Auditor's attention. The Members' Register must be checked up to see that all the balances together

agree with the total of the Subscribed Share Capital. If there is Work-in-Progress on the date of the Balance Sheet, a Statement in detail duly signed by the Works Manager stating how he arrived at the closing figure should be obtained. This Statement must be carefully checked with certified Production Statements and also with relative Cost Accounts. Whether the Financial Accounts are reconciled with the Cost Accounts should also be scrutinized.

5. **Bank Audit.** The Auditor before commencement of the Audit should obtain from the Agent a list of Books maintained by the Bank and ascertain whether there is any system of Internal Audit in operation. The Auditor should personally go to the Bank on the date of the Balance Sheet, viz., 30th June and 31st December of each year* to count cash in hand and inspect certificates from the Reserve Bank of India and other Banks regarding Cash Balances in their hand. He should obtain a list from the Bank of all the Investments and Securities and inspect them personally on the closing date and check the valuation with market prices. He should check all the Cheques received on the closing date late for collection, and see that they have been taken into account. All Bills for Collection in hand should be examined by the Auditor with a Schedule of such Bills. All Securities lodged with the Bank for Overdrafts, Loans and Cash Credits must be inspected by the Auditor. It must be seen that no advances have been made for more than the allowable limits which is usually 50% of the value of Securities lodged with the Bank. All the Ledger Balances of Current Accounts, Deposit Accounts and Loan Accounts must be checked. Provisions for Bad and Doubtful Debts and for Rebate on Bills Discounted must be made in the Accounts. The Title Deeds of all properties should be inspected by the Auditor. The Bank Statements of the clients must be initialled half-yearly by some responsible officer of the Bank and the closing balances must be checked by the Auditor by reference to the Clients' Ledgers. The General Ledger and the Certified Returns from Branches must be carefully checked.

* Bank Accounts are closed twice a year. The half-yearly closing is on the 30th June and the annual closing on the 31st December every year.

The Rules and Regulations as laid down by the Companies Act and the Banking Companies Act* must be strictly followed by the Auditor and the Final Accounts of the Bank must be drawn in terms of these Acts. The Auditor of a banking company will always (i) enquire of whether the Directors or any of the officers are interested in any particular Loan, (ii) examine the weight of guarantee extended by third parties in connection with a Loan and (iii) check up the proper maintenance of reserve ratio. Whenever a striking variation is noticed (a) in the volume of Deposit Liabilities and (b) in the rate of return on Investments, the causes of such variations must be enquired into.

The Bank Auditor is entrusted with the sacred duty of guarding the public money. The recent failures of many Banks indicate the colossal neglect of duty on the part of the Management and the Auditors. The glaring cases are of the Alliance Bank of Simla, Ltd. and the Bengal National Bank Ltd., where the depositors' money was squandered away through fictitious loans and advances. On the proper growth of banking habits much depends the economic well-being of a country. And the banking habit can be developed if the confidence of the public about the ability of the Banker to repay the money on demand is commanded. The public confidence is greatly shaken when there is a run on the Bank due to unbusinesslike policy pursued by the Management. The Auditor must look to it that the policy of a Bank in the matter of making Advances is neither too conservative nor too rash.

To efficiently conduct the Audit of Bank Accounts, a Bank Auditor must be thoroughly conversant with the activities of a Bank. A Bank is an institution that deals in credit. It obtains money by way of Deposits from the constituents and lends that money as Overdrafts and Advances to persons of the mercantile community and the public. Also the Bank renders multifarious other services to its customers and clientele. A clear grasp

* A Banking Company comes under the purview of the Banking Companies Act 1949, but is to be registered under the Companies Act 1956, as amended subsequently. Hence, the provisions of both pieces of legislation are to be complied with.

of the nature of the banking services will always stand the Bank Auditor in good stead. A fair idea of the activities of a Bank can be gained if the Bank Balance Sheet is taken under examination. According to the Banking Companies Act, such a Balance Sheet is to contain the following matters.

CAPITAL AND LIABILITIES	PROPERTY AND ASSETS
1. CAPITAL	1. CASH
2. RESERVE FUND AND OTHER RESERVES	2. BALANCES WITH OTHER BANKS
3. DEPOSITS AND OTHER ACCOUNTS	3. MONEY AT CALL AND SHORT NOTICE
4 BORROWINGS FROM OTHER BANKS, AGENTS, etc.	4. INVESTMENTS
5. BILLS PAYABLE	5. ADVANCES
6 BILLS FOR COLLECTION BEING BILLS RECEIVABLE (*per contra*)	6. BILLS FOR COLLECTION BEING BILLS RECEIVABLE *as per contra*
7. OTHER LIABILITIES (to be specified)	7. CONSTITUENTS' LIABILITIES FOR ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS *as per contra*
8 ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS (*per contra*)	8. PREMISES *less* Depreciation
9. PROFIT AND LOSS ACCOUNT (Cr. Bal.)	9. FURNITURE AND FIXTURES *less* Depreciation
10 CONTINGENT LIABILITIES.	10. OTHER ASSETS, including silver (to be specified)
	11. NON-BANKING ASSETS, acquired in satisfaction of claims (stating mode of valuation)
	12. PROFIT AND LOSS (Dr. Bal.)

PROPERTY AND ASSETS

Item No. 1 indicates Cash in Hand and Cash including foreign currency Notes with the Reserve Bank of India. **Item No. 2** shows balances with other Banks in India and outside India separately. **Item No. 3** indicates moneys lent to persons like Stock Brokers and Bill Brokers on condition that they are to be repaid as soon as demanded or after a Short Notice of repayment has been served. **Item No. 4** shows the investing of the Bank's funds in Government Papers (Gilt-

edged Securities) ; in Trustee Securities including Government Treasury Bills ; in Shares and Debentures and other Investments of approved Companies ; and in Gold. **Item No. 5** will show the Advances made by the Bank in India and outside India under two heads, viz., (i) Loans, Cash Credits and Overdrafts and (ii) Bills discounted and purchased. Cash Credits signify an arrangement by which a customer's Account will be credited by a specified amount, to be withdrawn as and when required (the entry in the Account Books being to debit Cash Credits Account and to credit the customer's Deposit Account). Overdraft is a facility extended by a Bank to its constituents by which cheques are honoured by payment even though there may not be funds warranting such payments. In all of the cases of ordinary Loans, Overdrafts and Cash Credits there must be adequate securities lodged with the Bank. One of the cardinal functions of a Bank is to advance money to its constituents by discounting Bills of Exchange presented before it or by purchasing them outright. International Trade is fostered when there is arrangement for the discounting of foreign Bills. The Advances made by a Bank must be shown giving separately the details of the following :—

(i) Debts considered good in respect of which the Bank is fully secured.

(ii) Debts considered good for which the Bank holds no other Security than the Debtors' personal security.

(iii) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the Debtor.

(iv) Debts considered doubtful or bad not provided for.

(v) Debts due by Directors of Officers of the Bank or any of them either severally or jointly with any other person.

(vi) Debts due to companies or firms in which the Directors of the Bank are interested as Directors, Partners or Managing Agents, or in the case of Private Companies as Members.

(vii) Maximum total amount of loans including temporary advances)made at any time during the year to Directors or Managers or Officers of the company.

(viii) Maximum total amount of loans, including temporary advances granted during the year to the companies or firms in which the Directors of the Bank are interested as Directors, Partners or Managing Agents or in the case of Private Companies as Members.

(ix) Due from Banks.

Item No. 6 represents Bills of Exchange that have been lodged with the Bank for being collected on behalf of its constituents. For the Bank these constitute both an asset and a Liability—*Asset*, because the Bank will realise the proceeds of the Bills and *Liability* because the Bank remains liable for making over the money to the Holder in Due Course (Payee). The same matter, therefore, is also exhibited on the Liabilities side under Item No. 6 (*per contra*) Another case where an item is shown both as an Asset and as a Liability (*per contra*) is **Item No. 7** of the Assets side in a Bank Balance Sheet (which is **Item No. 8** on the other side) Such a case arises where the Bank accepts or endorses an Instrument on behalf of its constituents, who remain liable for the payment the Bank will make. What are the constituents' Liabilities would be considered Assets for the Banker. In a different language this thing will appear on the Liabilities side under **Item No. 8** for the reason that a liability devolves on the shoulder of the Bank consequent on the acceptance or the endorsement. The meaning of the other items on the Assets side is obvious.

CAPITAL AND LIABILITIES

Item No. 1 indicates Capital raised by issue of Shares. The following groupings must be there : *Authorised Capital, Issued Capital* and *Subscribed Capital.* From the amount of Subscribed Capital should be deducted the Calls Unpaid and to it shall be added the amount received on Forfeited Shares. **Item No. 2** shows that so much of the profits and surplus

derived from the banking business and from other sources was not given away as Dividend to shareholders, but was utilised in building Reserve Fund and Reserves. The difference between a Reserve Fund and a Reserve has earlier been discussed under Chapter X. **Item No. 3** indicates the Deposit liability shouldered by a Bank. This liability is shown divided under three different Accounts : (i) Current Account, (ii) Fixed Deposit Account and (iii) Savings Deposit Account. The amounts standing to the credit of the Current Accounts constitute the *demand liability* of a Bank ; for, the Bank has to remain prepared for meeting claims for payment for which no notice would be served. Little income can therefore be earned from the investment of these moneys, and on that account hardly is any interest allowed to the Deposits of these Accounts. The amounts of the other two Accounts constitute the *time liability* for the Bank Withdrawals against a Fixed Deposit Account cannot be done till the expiry of a fixed period (customers would be charged if earlier withdrawal is effected). In the case of a Savings Deposit Account the Depositors are allowed to withdraw money from their Accounts only once a week (the idea is to foster the savings of the public). The amounts standing at the credit of Fixed Deposit Accounts and Savings Deposit Accounts can, therefore, be made available for investment bringing a good yield ; for, the Bank would find a time to meet a demand for payment (during which time it would be able to call back the lent moneys conditioned to be repaid at Call or at Short Notice). The Bank, therefore, allows an interest to the Depositors of these Accounts. **Item No. 7** will show such Liabilities of a Bank as Pension or Insurance Fund, Unclaimed Dividends, Advance Payments, Rebate on Bills Discounted, etc. The term *Rebate on Bills Discounted* requires explanation. When Bills of Exchange are discounted, the Discount Account is credited by the Bank. A part of the Discount Account which relates to Bills not matured till the Balance Sheet date cannot be considered profit of the Bank. An adjustment, therefore is done on the closing date by debiting the Discount Account and crediting the Rebate on Bills Discounted Account. The credit balance of the latter Account will appear as a Liability on the Bank Balance Sheet. The

meaning of the other Liability Heads is clear from their very names.

For prescribed forms of Bank Profit and Loss Account and Bank Balance Sheet and also for specimen Bank Audit Reports please refer to the Appendices portion of the Book.

6. **Audit of a Cinema House.** The checking of the Cash Book will be similar to that in other Audits. Cash in hand must be counted and Securities in the safe must be inspected by the Auditor personally on the date of the Balance Sheet. The postings and castings of all the Books should be checked. Petty Cash Book must be vouched and Petty Cash in hand on the closing date counted. Wages and Salaries must be checked in detail with the Muster-Rolls and the Salary Book. The Purchases Day Book should be checked with the original invoices. Sales Day Book should be vouched with the Bill Books or copies of Bills issued to customers along with forwarding challans. There must be strict internal control regarding the printing and use of Cinema Tickets which must be consecutively numbered and preferably entered in a Ticket Stock Book and kept under lock and key by some responsible officer of the Cinema. All the receipts from Tickets must be entered in a separate Book which must be checked by the Auditor with Ticket counterfoils. An Entertainment Tax Book should be maintained showing gross earnings and tax payable to the Government with dates. When such taxes are actually paid the payments should be traced into the Cash Book. In the case of sales of Cigarettes, Drinks, etc., separate Stock Books should be maintained by the Management for these goods showing opening balances. The Sales must be checked by the Auditor with Cash Memos or tickets as the case may be. Separate closing stock certificates must be obtained by the Auditor of these goods and he should see that the figures agree with those shown on the Balance Sheet under Audit. Amounts received from parties for advertisements shown on the screen in the Cinema Hall should be checked with the Receipt counterfoils. Title Deeds of Land and Buildings and other properties must be verified by the Auditor and he must see that proper depreciations on all fixed Assets have been provided for in the Accounts.

7. **Colliery Audit.** The Cash Book must be carefully checked as described in previous audits. The closing Cash in Hand must be counted by the Auditor on the close of business on the date of the Balance Sheet. The Petty Cash Book must be vouched and the closing Petty Cash counted, like the cash-in-hand. The Wages Book should be checked with Muster Rolls, the Wages Sheets being duly initialled by some officer of the Colliery. All the postings and castings must be checked. The Sales Day Book and the Purchases Day Book must be fully vouched. The list of Sundry Debtors and that of Sundry Creditors must be checked with respective Ledgers and with the Confirmation of their balances on the date of the Balance Sheet The closing Stock of Coal must be certified by the Manager and a Statement submitted to the Auditor in support of his certificate showing opening balance at the beginning of the year, Coals raised during the period, Coals consumed in the boiler, the Sale of Coal during the year and the Closing Stock of Coal. The Closing Stock must be valued at average cost or controlled selling rate, whichever is lower. Proper Provision for Depreciation must be made in the Accounts on Building, Machinery, Tools, Trucks, Lines, and Leasehold and Freehold Properties. The Auditor should personally see all the Title Deeds and other Securities.

8. **Audit of Insurance Companies.** Insurance companies usually conduct the following classes of business, viz., (a) Life Insurance which is now nationalised and conducted by the Life Insurance Corporation of India under the Governmental supervision, (b) Fire Insurance, (c) Marine Insurance, (d) Accident Insurance, (e) Motor Car Insurance, and (f) Employer's Liability Insurance and it is the duty of the Auditor to be conversant with the latest modifications of the Insurance Act before he undertakes an Insurance Audit. He must be acquainted also with all the Forms of Accounts and Returns which, under the new Insurance regulations, the Insurance Companies are required to submit to the Controller of Insurances yearly. In the case of a Life Assurance Company, the Audit of which is conducted by Government Auditors, the Premium Income must be checked

with the copies of Policies as per Policy Books, Cover Notes,* Renewal Registers, Lapsed Policies, etc. A monthly summary of all Premiums received should be compiled from these documents showing in a Summary Abstract Book, the gross Premium received *less* Commission paid. The Commission payable to the Agents should be verified with the Statements of Accounts, submitted by the Agents, together with the Agents' Ledger. All outstanding Commissions must be provided for in the Accounts. All the claims paid to clients must be checked with cancelled Policies, Death Certificates, Discharge Notes, etc. Claims which were notified but not admitted must be provided for in the Accounts. Surrenders must be checked with endorsed Policies and Cash Receipts given by Policy holders. Annuity payments should be checked with the Cash Receipts given by the beneficiaries. The Re-Insurance transactions and Re-Insurance recoveries must be examined. All outstandings and all annuities accrued must be provided for in the Account. The Securities and Investments must be personally inspected by the Auditor on the date of the Balance Sheet. Similar procedure should be adopted in case of Fire, Marine, Accident and other Insurance Companies The losses and claims paid should be checked with claim papers. Surveyors' Certificate and other relevant documents. The Premium Reserve carried forward in the Accounts should be carefully studied. The Auditor should see that Investment Fluctuation Fund is properly maintained, as Insurance Companies make large investments. The Treaties (Agreements) with the Ceding Companies† in the cases of Re-Insurance must be personally examined by the Auditor. The outstanding balances of the Ceding Companies on the date of the Balance Sheet must be checked by the Auditor and must be reconciled with their Statements.

9. Audit of Motor Transport Companies. The main system in operation for the collection of money through

* Before a Policy is prepared, a Cover Note is issued in favour of the insured on receipt of the first premium to cover the risk of the Policy.

† By a Ceding Company should be meant an insurance company which enters into a re-insurance contract with another insurance company for shifting a portion of the risk burden.

Passenger and Goods service should be studied carefully by the Auditor. The conductors' Way Bills should be checked with the Traffic Book. Money received from the sale of tickets to passengers must be carefully checked. Advertisement receipts should be vouched with contracts entered into with parties. If motor cars are purchased through Hire Purchase system, the Agreements must be inspected by the Auditor. The payments on account of Hire must be taken into account. Proper Interest must be charged to Revenue also. It should be seen that adequate Depreciation has been provided for in the Accounts. The Articles of Association and the Memorandum of Association of the company must be carefully studied together with the Directors' and the Shareholders' Minute Books. The Cash Book and Traffic Receipt Books should be thoroughly vouched. The Stock Schedule must be checked and a Closing Stock certificate must be obtained from the Management.

10. **Audit of Shipping Companies.** The Articles of Association and the Memorandum of Association of the Company must be studied by the Auditor together with the Agreements between Captains of Vessels and the Management. The internal system of check should be observed and the Cash Book should be vouched fully The Voyage Account and all receipts and payments in connection with the voyages must be checked. Stores consumed during the voyage and the Stores in hand should be verified by the Auditor. The Freight Receipts should be checked with the Agents' Advices and Returns. Passenger fares should be checked with Receipt Counterfoils. All outstanding expenses in connection with a voyage must be brought into account. The Sundry Debtors' List for freight should be taken into verification and the Agents' Commission should be checked thoroughly. The Charter Party Agreement and the Insurance Policy must be examined and all the Investments and Securities of the Company duly verified. It should be seen that proper depreciation has been provided for in the Accounts. Capital Expenditure must be vouched by reference to the supporting documents and all repairs and maintenance should be charged to the Voyage Account. All Dividends paid and those declared but not claimed should be checked as in a Joint

Stock Company Audit. Directors' and Shareholders' Minute Books and the Share Capital Accounts must also be brought under examination.

11. **Audit of Solicitors' Accounts.** The method in operation for recording the receipt of money from clients should be studied. All the postings and castings of the Clients' Cash Book and Ledgers must be checked. The Solicitors' Cash Book should be properly vouched. The Bill Books must be checked with copies of Bills. Premiums received from Articled clerks must be vouched with the Agreement. All outstanding costs incurred on behalf of clients should be charged to their Accounts All the closing balances of Clients' Ledger must be checked with their confirmations. The Payments made to the Counsels* for attending cases should be verified with their Receipts. Adequate Provision for Bad and Doubtful Debts must be made. All the Liabilities and outstandings should be thoroughly vouched and taken into Account.

12. **Audit of Publishers' Accounts.** The Cash Book and Petty Cash Book must be checked. All the castings and postings should be completed. If the Publishing concern is a limited company, the Memorandum and the Articles of Association must be studied. The Production Account in respect of all the books published must be checked separately including costs of Types, Blocks, Printing, Paper, Binding, etc. The Copyright should be taken at cost price in the Balance Sheet. All the closing stock must be checked with the Stock Schedule and a Certificate from the Management obtained by the Auditor. All Books sent to the Booksellers must be checked. Authors' Royalties should be vouched with the Agreement entered into with the Author and the correctness of calculations examined. Proper provision must be made for Bad and Doubtful Debts.

13. **Audit of Gas Companies.** The Memorandum and the Articles of Association of the Company must be studied by the Auditor. The Cash Book and the Petty Cash Book should be

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* Barristers employed on one side in suit (*for the Crown, the prosecution, the defence*).

vouched fully. Receipts should be checked with Receipt Counterfoils and payments with Payment Vouchers and Receipts from parties. The Rental Ledger* should be checked with Meter Book where consumers' monthly consumption of gas is recorded. All outstandings from Customers should be checked with Customers' Ledgers. Contracts for Government and Public Lighting should be examined in detail. The Purchase Book should be checked with the original invoices. Capital Expenditure must be vouched together with Capital Receipts. Deposit Accounts of consumers should be checked with Interest Payable Accounts and with Deposit Receipts†. Cash Sales should be verified with copies of Cash Memos and National Cash Register Records. Adequate Provision must be made for Depreciation Fund. The Closing Stock should be physically verified by reference to the Stock Schedule and the Certificate obtained from the Management All Investments and Securities must be examined by the Auditor personally on the Balance Sheet date. All the Dividends paid and payable should be checked with (i) Counterfoils of Dividend Warrants, (ii) Dividend Register, (iii) Bank Statements, and (iv) Shareholders' Minute Book. Allocation between Capital and Revenue Expenditure must be carefully scrutinized by the Auditor. The Share Capital Audit will be on the same line as that in an ordinary Limited Company. A Gas Company is a Statutory Company ; for, it comes under a Special Statute passed by the Parliament called 'Gas Companies Act'. It will, however, be registered under the Companies Act. The Auditor should see that the provisions of both pieces of legislation are duly complied with by the Gas Company under Audit. Whether Accounts have all been prepared, in the *special form* under the Double Account system, should engage the Auditor's attention.

* The Rental Ledger contains records of the consumers' monthly rents for meters installed in their premises ; also, it records charges for consumption of gas.

† Deposit Receipts are issued by Gas Companies when moneys are deposited by consumers for meters hired. And the Company is to pay an interest for the deposited amount.

For prescribed forms of Final Accounts of an insurance company and for specimen Audit Reports, please refer to the Appendices portion of the book.

14. Audit of Schools and Colleges. At the time of conducting the Audit of Accounts maintained by Schools and Colleges, the Auditor should concentrate his attention to the following points :—

(1) It should be seen that the Final Accounts are compiled in terms of the directions issued by the Secretary of the Education Department.

(2) The Income from tuition fees and other charges payable by the students should be ascertained by reference to the Students' Registers, the Prospectus of the institution containing rules regarding payment of fees &c., and the counterfoils of Receipts.

(3) It should be checked up that all of the sundry fees were realised and recorded in the Account Books excepting the cases of arrears.

(4) All Income from fees should be traced into the Cash Book.

(5) The copies of Letters of Appointment of Teachers. Professors and other employees of the institution should be examined for verifying that proper amounts are paid to them every month as per record in the Cash Book. Proper Receipts must be seen of such payments.

(6) The expenses on account of the purchase of Library Books should be verified with Sanctions from the Library Committee and Receipts from Suppliers.

(7) On the Financial Closing date physical verification must be made of all Library Books in Hand and all Cash Balances.

(8) Banker's Certificate should be obtained regarding Bank Balance and a Bank Reconciliation Statement drawn up if the Bank Balance as shown by the Cash Book differs from that exhibited by the Bank Statement.

(9) Proper Depreciation must be provided for on Buildings, Furniture, Books, etc.

(10) Special inquiry should be made of—(i) whether any fees receivable are considered doubtful of recovery ; (ii) whether the special grants are expended for the particular purposes only for which they are sanctioned ; (iii) whether there is effective internal check that would render adoption of foul means by the ministerial staff difficult ; and (iv) whether all of the disbursements are supported by authentic vouchers.

15. **Audit of a Charitable Institution.** In Auditing the Accounts of a Charitable Institution the following should be included in the programme of the Auditor :—

(1) A list of all Donations and Subscriptions received during the year should be obtained from the Management and that verified by reference to the Cash Book.

(2) The Cash Book should be checked in full with Receipt counterfoils which must be consecutively numbered. This is for ensuring that all donations and subscriptions received have been properly incorporated in the List.

(3) The income from Legacies* should be checked with Solicitors' Correspondence, Legacy Register and Counterfoils of Receipts issued to parties.

(4) The income from Investments should be verified with Bank Advices and Investment Register.

(5) Rent receipts should be checked with the Agreements, the Rent Register and the Receipt Counterfoils.

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* *Legacy* : Gift left by will.

(6) All outstanding incomes must be brought into the accounts, and it should be seen whether any amount is considered doubtful of recovery.

(7) Charities granted to parties should be checked with Sanctions from the Committee of Management and the Receipts from parties.

(8) It should be seen that an Income and Expenditure Account is prepared, all outstanding and unexpired amounts being properly taken into account and that it is followed by a duly drawn up Balance Sheet.

16. **Audit of Contractors' Accounts.** While subjecting the Accounts of a Contractor to a scientific Audit, the Auditor should focus his attention to the following points :—

(1) If there are 'internal check' and 'internal control' in operation

(2) Whether there is an efficient costing method employed for valuing the amount of Uncompleted Contracts.

(3) Whether the Work-in-Progress is valued at Prime Cost, i.e., on the basis of Direct Materials consumed and Direct Labour engaged or whether Overhead Charges are also included

(4) Whether the system of purchase of Raw Materials and valuation of Closing Stock is fault-free.

(5) Whether Closing Stock is physically verified on the closing day of the financial year.

(6) Whether any profit is taken in the Accounts on Uncompleted Contracts ; if so, on what basis.

(7) Whether all of the expenses are supported by authentic vouchers.

(8) Whether separate Accounts are maintained for various Contracts, and Profit or Loss is determined for every Contract separately.

(9) Whether all the Outstanding Income and Expenditure have been incorporated into the Final Accounts.

17. Audit of Hotels and Restaurants. At the time of conducting a Hotel Audit, the Auditor should pay his attention to the following points :—

(1) The Boarders' Book should be examined with the Boarders' Register and it must be seen that all receipts from the Visitors and the Boarders are incorporated into the Cash Book.

(2) The Cash Book should be examined with the Receipt Counterfoils, the originals of which are given (i) to the Boarders at the time of their monthly settlement of Accounts, and (ii) to the temporary visitors while settling up their Bills.

(3) The Visitors' Book should be verified with the Visitors' Register to see that all amounts received from them are recorded in the Cash Book. The Receipt counterfoils should also be examined in this connection

(4) It should be seen whether proper depreciation has been provided in the Accounts for Premises, Furniture, Bed, Linen, Crockery, etc.

(5) All the daily market expenses for Provisions, Stores, Vegetables, Fish and Meat should be checked with Daily Statements submitted by bazaar-goers, supported by vouchers.

(6) All petty expenses should be checked with relative vouchers.

(7) It should be seen that all outstanding or prepaid expenses and all accrued incomes or incomes received in advance are duly brought into the Final Accounts.

18. Audit of a Newspaper Publishing House. The Auditor conducting a Newspaper Audit would always be required to chalk out his programme as narrated below :—

(1) The Income from daily advertisements should be checked with Advertisement Day Book and copies of Receipts issued to parties.

(2) The total of daily collections should be traced into the Cash Book under Advertisement receipts.

(3) The Production Account should be scrutinized to ascertain the number of daily papers printed and checked up with the Agent's Distribution Sheets to verify the number of copies issued to public.

(4) The income from the sale of newspapers should be verified with the Agents' Certified Returns and traced into the Cash Book.

(5) All the expenses as per Cash Book should be checked with vouchers and relative documents.

(6) The Service Agreements of the Editor, the Sub-Editors, the Manager, the Printers and others should be carefully examined with a view to seeing that establishment expenses have been properly charged.

(7) It should be seen that proper depreciation has been provided in the Final Accounts for Premises, Printing Machines and Printing matters.

(8) All outstanding income and expenditure should be taken into account.

(9) It should be seen that proper allowance has been made for machines which are obsolete.

QUESTIONS ON CHAPTER XVI

1. As an Auditor of a *Chemists' Shop* on what special points would you concentrate your work ?

[*Hints* : (a) Examine whether there is any Internal check in operation regarding Cash and Credit Sales and Stock.

(b) Check Cash Sales with Cash Memos and Credit Sales with Outward Receipted challans and Copies of Bills issued to Customers.

(c) Trace the Amounts received on account of Cash and Credit Sales into the Cash Book, the Bank Statements and the Pay-in-Slips.

(d) Check the Purchases Book with Original Invoices and Order Books.

(e) Vouch all Payments with Counterfoils of Cheque Books and Receipts from parties.

(f) See that proper Stock Book is maintained for Stock of Medicine with columns for (i) Opening Balance, (ii) Issues, and (iii) Closing Balance.
(g) Make a physical examination of Closing Stock with Certified Inventory.]

2. How will you conduct the Audit of a *Transport Company* ?

[*Hints* : (a) Passenger receipts and Goods receipts should be checked with Returns of Tickets sold and Copies of Way Bills.

(b) Receipts from Advertisements to be vouched with Agreements with parties and copies of Receipts given to them.

(c) Capital Expenditure, e.g., Purchase of Lorries and Vehicles to be vouched with Original Invoices, Order Books and Parties' Receipts.

(d) Expenditure for Repairs and Maintenance to be checked with Parties' Estimates, Bills, Cheque Counterfoils and Parties' Receipts.

(e) Proper provision for Depreciation as per Income Tax Regulations to be inquired about.

(f) A Certified Inventory of all Lorries, Vehicles, Tyres, etc., to be obtained from the Management on the Balance Sheet date and a physical verification to be conducted, wherever possible.

(g) A proper Internal Check to be insisted upon on all movements of goods, money and material.]

3. To what special points would you direct your attention as the Auditor of a Hotel ?

[*Hints* : (a) Verify the amounts received from temporary visitors as sales proceeds of Meals, Wines, etc., by taking the Cash Book and the Copies of Cash Memos into examination.

(b) Check the amounts received from Residents of the Hotel by reference to the Visitors' Ledger, the Visitors' Book, the Copies of Bills and the Counterfoils of the Receipt Book.

(c) Verify the Purchases of Provisions, Wines, etc., from the Purchases Book, the Original Invoices and the parties' Bills and Receipts.

(d) See if there is any Internal Check in operation regarding Cash Sales and Purchases.

(e) Obtain a Certified List of Closing Stock of Wines and Provisions and make a physical verification on the Balance Sheet date.]

4. How will you conduct the Audit of a Club ?

[*Hints* : (a) Members' Entrance Fees and Subscriptions should be vouched with Applications from Members, Receipt Counterfoils, Minutes of Club Committee Meetings and Members' Register.

(b) It should be seen that Subscriptions received in Advance and Outstanding Subscriptions are properly recorded in the Accounts.

(c) Income from Sale of Refreshments should be checked with Cash Memos.

(d) Purchases of Food and Provision and also of Sports Materials should be checked with Original Invoices, Order Book and Parties' Bills and Receipts.

(e) A Certified List of Foodstuff, Sports Materials, Investments and Furniture should be obtained and a physical verification made on the Balance Sheet date.]

5. To what particular points should you direct your attention at the time of a *Cinema* Audit ?

[*Hints* (a) Check the income from the Sale of Tickets with Daily Returns of Tickets sold at each show as certified by the Manager.

(b) See if there is any internal check on Cash Sales of Tickets and Stock of Printed Tickets.

(c) Ascertain whether Entertainment Taxes have been properly collected and paid into Reserve Bank of India.

(d) Check the Film Hire amount with the Distributors' Agreements and Receipts.

(e) Check the operating expenses with the Operators' Vouchers and Receipts and Service Agreements.

(f) Advances given to Distributors and Producers should be checked with their Correspondence and Receipts.

(g) Certified Inventory of Machinery, Films, Furniture, etc., should be checked by a personal inspection on Balance Sheet date.]

6. On what special points would you concentrate your attention at the time of the Audit of a *Tea Company*?

[*Hints* (a) Ascertain whether the Tea Garden Books maintained at the Garden are properly audited at that end by a Qualified Branch Auditor and whether proper Returns are submitted at Head Office, certified by the Manager and the Auditor and whether they have been incorporated in the Head office Books.

(b) Tea Sales should be checked with tea brokers' Account Sales showing the quantity sold and the proceeds of the Sales.

(c) Excise Duty paid should be checked with Excise Receipts.

(d) All payments should be checked with Payment Vouchers and Parties' Receipts and Bills.

(e) Purchase and Sale of Export Quotas should be checked with Statements and Receipts.

(f) A List of Closing Stock of Tea duly verified and certified by the Manager and the Auditor should be obtained and a physical verification arranged wherever possible.]

7. How will you conduct the Audit of a *Coal Company*?

[*Hints*: (a) If there is a qualified Branch Auditor at the Colliery, it should be seen that Certified Returns from the Auditor are submitted to Head Office in time and that they are duly incorporated in the Head Office Books.

(b) Royalty payments should be vouched with Leases and Agreements.

(c) All Sales should be vouched by reference to Wagon Despatch Statements, Contracts with parties, Challans and Receipt Counterfoils.

(d) Wage payment should be checked by taking into examination Parties' Receipts, Muster-Rolls, Wages Abstracts and other relevant documents.

(e) A Certified List of Closing Stock should be obtained from the Branch Auditor showing (i) Opening Balance, (ii) Raisings of Coal during the period under review, (iii) Despatches, and (iv) Balance at Close.

(f) As in other Audits, here, too, an efficient system of Internal Check should be insisted upon.]

How would you conduct the Audit of a *College* ?

[*Hints* (a) Get a certified copy of the Budget, duly passed by the Governing Body of the institution, to examine the Heads of Income and Expenditure.

(b) Check the Admission Fees realised from the students by reference to the duplicates of Receipts issued to their favour.

(c) Vouch monthly collection of tuition fees with the Counterfoils of Fee Books.

(d) Ascertain the total amount of tuition fees and other fees payable by the students monthly from the Attendance Register of all the sections of various classes and see that the total collections (together with listed arrears) tally with the ascertained figure.

(e) If any Government Grants are received, vouch the amount with Receipt Counterfoils and the Correspondence in connection therewith.

(f) Vouch Salaries paid to the Staff, Professorial, Ministerial and Menial, by reference to the Salary Book (Acquittance Roll), Service Agreement and the Personal File.

(g) Inspect the Closing Stock of Library Books, Furniture and Fixture, &c., personally on the Balance Sheet date along with a Certified List.

(h) Be satisfied that the system of recording the incomings and outgoings of Cash does not leave room for fraudulent practices.

(i) See that the Accounts are all compiled in keeping with Instructions received from the Education Department.]

9. To what special points should the Auditor of a Shipping Company concentrate his attention ?

[*Hints* : (a) The extent of Internal Check in operation should be studied.

(b) Income from the Sale of Passenger Tickets and Freight on Goods should be checked with the respective Summaries, Counterfoils of Tickets and Copies of Freight Bills.

(c) It is to be seen that separate Accounts are kept for each vessel and a separate Account is compiled for each voyage which should be debited with Revenue Expenses and credited with Freight and Passage Money.

(d) Consumable Stores in hand after the completion of the Voyage should be credited to the Voyage Account as Closing Stores.

(e) Outstanding liabilities on each Voyage and Accrued Incomes should be included in the Voyage Account.

(f) It is to be seen that the Agents' Statements of Accounts and Insurance Premiums have been incorporated into the Accounts after proper adjustments.

(g) It is to be checked up whether Commissions, Depreciations and other Revenue Charges have been correctly set off against the Profits.

(h) All Capital Expenditure and all expenses of Repairs and Renewals should be vouched by taking into examination the relevant vouchers and documents ; and the proper allocation between Capital Expenditure and Revenue Expenditure should always be insisted upon.]

10. Enumerate some special points you will note at the time of the Audit of an Electric Company.

[*Hints* : (a) The system of Internal Check in operation should be studied.

(b) Provisions of the Special Electricity Act should be examined.

(c) All costs of Replacements and Repairs should be charged to Revenue and 'Additions to Capital Equipments should be Capitalised.

(d) Incomes from consumption of electricity by consumers should be checked with Consumers' Ledgers and other documents.

(e) All outstandings from consumers should be verified from the Consumers' Ledgers and traced into the Balance Sheet.

(f) Contracts with Corporations, Port Trusts, Improvement Trusts and Other Public Bodies should be examined to ascertain the rate of consumption per unit and see that income from such consumption has been properly accounted for.

(g) Contracts with factories, workshops, etc., for current consumed in respect of Motive Power should be scrutinized with a view to ascertaining the correct amounts realised and provided for in the Accounts.

(h) Proper allocation of all expenses for (a) Generation of Electricity (b) Distribution of Electricity and (c) Management of the concern must have been done. This allocation should be certified by a responsible official, e.g., the Commercial Manager.

(i) Depreciation should be properly provided for on Machinery, Buildings, Mains, Meters, Power Houses, etc.

(j) It must be seen that Final Accounts are drawn up under Double Account system and in terms of the Electricity Act.]

11. What are the special points to be considered at the time of the Audit of a Contractor's Account ?

[*Hints* : (a) Whether there are proper records of consumable Stores regarding receipts from suppliers and issues to different Contracts and also if there is any internal check in operation.

(b) The method of the payment of Wages to Workmen, the proper allocation of wages between Contracts, and the extent of safeguards adopted at the time of wage disbursement.

(c) Whether Depreciation on Plant used for different Contracts is allocated correctly.

(d) Whether separate Account is maintained for each Contract with proper allocation of Overhead Expenses.

(e) The method of valuation of uncompleted Contracts, and the proper provision for all liabilities including unforeseen expenses.

(f) Whether anticipated profits on Uncompleted Contracts have been taken into credit in the Profit and Loss Account ; if so, whether the inclusion has been on cash basis.

(g) Due verification of the amounts received on Contracts with Architects' Certificates.

(h) Taking the Contracts with parties, the Bill of Cost of the Contractor, and his detailed Estimate into examination.

(i) Obtaining a Certified Inventory of the Stock-in-trade and other Assets from the Management and conducting a physical verification on the Balance Sheet date.]

12. How will you Audit the Accounts of a company publishing News-papers ?

[*Hints* : (a) Receipts from Advertisements should be checked with the Counterfoils of Receipt Books and with the Contracts with customers.

(b) Subscriptions (Collections on the sale of Newspapers) should be verified from Statements of Newspaper Agents and the Issue Register indicating number of Newspapers handed over to the Agents.

(c) Commission paid to the Agents should be checked with their Receipts, Statements and terms of Agreement.

(d) All expenses of Printing should be vouched with the Bills, Receipts and other relevant Documents.

(e) Cost of Machines and Printing Materials should be checked with original invoices and parties' Receipts.

(f) Depreciation on Plant and Machinery, Printing Materials, Premises, etc., should be provided for as laid down in the Income-Tax Schedule.

(g) A Certified Inventory should be obtained from the Management of the Closing Stock of Printing Matters and a physical verification conducted on the Balance Sheet date.

(h) Cost of Production of Newspapers should be checked with the Production Statement duly supported by relevant Documents and Record .]

Appendix A

PORTION OF THE COMPANIES ACT, 1956 (As modified up to the 1st. May, 1961) DWELLING ON "ACCOUNTS" AND "AUDIT"

Accounts

Books of account to be kept by company.

209. [1][(*1*) Every company shall keep at its registered office proper books of account with respect to—

(*a*) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place ;

(*b*) all sales and purchases of goods by the company ; and

(*c*) the assets and liabilities of the company :

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the Board of directors may decide and when the Board of directors so decides, the company shall, within seven days of the decision, file with the Registrar a notice in writing giving the full address of that other place.]

(2) Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions of sub-section (*1*), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (*1*).

(3) For the purposes of sub-sections (*1*) and (*2*), proper books of account shall not be deemed to be kept with respect to the matters specified therein, if there are not kept such books as are necessary to give a true and fair view of the state of the

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[1] Subs. by Act 65 of 1960, s. 60, for sub-section (*1*).

affairs of the company or branch office, as the case may be, and to explain its transactions

(4) The books of account shall be open to inspection by any director during business hours :

[1][Provided that the books of accounts shall also be open to inspection by the Registrar or by any officer of Government authorised by the Central Government in this behalf if in the opinion of the Registrar or such officer sufficient cause exists for the inspection of the books of account.]

[1][(4A) The books of account of every company relating to a period of not less than eight years immediately preceding the current year shall be preserved in good order :

Provided that in the case of a company incorporated less than eight years before the current year, the books of account for the entire period preceding the current year shall be so preserved.]

(5) If any of the persons referred to in sub-section (6) fails to take all reasonable steps to secure compliance by the company with the requirements of this section, or has by his own wilful act been the cause of any default by the company thereunder, he shall, in respect of each offence, be punishable with [2][imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both] :

Provided that in any proceedings against a person in respect of an offence under this section consisting of a failure to take reasonable steps to secure compliance by the company with the requirements of this section, it shall be a defence to prove [3]* * * that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty :

[1][Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.]

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[1] Ins. by Act 65 of 1960, s. 60.

[2] Subs. by s. 60, *ibid.*, for "fine which may extend to one thousand rupees".

[3] The words "that he had reasonable ground to believe, and did believe" omitted by s. 60, *ibid.*

(6) The persons referred to in sub-section (5) are the following namely :—

(a) where the company has a managing agent [4][secretaries and treasurers or managing director or manager], such managing agent [4][secretaries and treasurers or managing director or manager] ;

(b) where such managing agent or secretaries and treasurers are a firm, every partner in the firm ;

(c) where such managing agent or secretaries and treasurers are a body corporate, every director of such body corporate ; and

(d) where the company has neither a managing agent nor [1][secretaries and treasurers nor managing director nor manager, every director of the company].

(7) If any person, not being a person referred to in sub-section (6), having been charged by the managing agent, secretaries and treasurers, [2][managing director, manager] or Board of directors, as the case may be, with the duty of seeing that the requirements of this section are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with [3][imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both].

Annual accounts and balance sheet.

210. (1) At every annual general meeting of a company held in pursuance of section 166, the Board of directors of the company shall lay before the company—

(a) a balance sheet as at the end of the period specified in sub-section (3) ; and

(b) a profit and loss account for that period.

[4] Subs. by s. 60, *ibid.*, for "or secretaries and treasurers".

[1] Subs. by Act 65 of 1960, s. 60 for "secretaries and treasurers, every director of the company".

[2] Ins. by s. 60, *ibid.*

[3] Subs. by s. 60, *ibid.*, for "fine which may extend to one thousand rupees"

(2) In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of a profit and loss account, and all references to "profit and loss account", "profit" and "loss" in this section and elsewhere in this Act, shall be construed, in relation to such a company, as references respectively to the "income and expenditure account", "the excess of income over expenditure", and "the excess of expenditure over income".

(3) The profit and loss account shall relate—

(a) in the case of the first annual general meeting of the company, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months ; and

[1][(b) in the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months, or in cases where an extension of time has been granted for holding the meeting under the second proviso to sub-section (1) of section 166, by more than six months and the extension so granted.]

(4) The period to which the account aforesaid relates is referred to in this Act as a "financial year" ; and it may be less or more than a calendar year, but it shall not exceed fifteen months :

Provided that it may extend to eighteen months where special permission has been granted in that behalf by the Registrar.

(5) If any person, being a director of a company, fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or

[1] Subs. by Act 65 of 1960, s. 61, for cl. (b).

with fine which may extend to one thousand rupees, or with both :

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove [2]* * * that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(*6*) If any person, not being a director of the company, having been charged by the Board of directors with the duty of seeing that the provisions of this section are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

Form and contents of balance sheet and profit and loss account

211. [1][(*1*) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of this section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in any particular case ; and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "notes" at the end of that Part :

Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other

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[2] The words "that he had reasonable ground to believe and did believe" omitted by s. 61, *ibid.*

[1] Subs. by Act 65 of 1960, s. 62, for sub-section (*1*).

class of company for which a form of balance sheet has been specified in or under the Act governing such class of company.]

(2) Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto :

Provided that nothing contained in this sub-section shall apply to any insurance or banking company [2][or any company engaged in the generation or supply of electricity], or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

(3) The Central Government may, by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements in Schedule VI if, in its opinion, it is necessary to grant the exemption in the [3][public interest].

Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(4) The Central Government may, on the application or with the consent of the Board of directors of the company, by order, modify in relation to that company any of the requirements of this Act as to the matters to be stated in the company's balance sheet or profit and loss account for the purpose of adapting them to the circumstances of the company.

(5) The balance sheet and the profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company merely by reason of the fact that they do not disclose—

4 of 1938 (i) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938 ;

[2] Ins. by s. 62, *ibid.*
[3] Subs. by s. 62, *ibid.*, for "national interest".

(ii) in the case of a banking company, any matters which are not required to be disclosed by the Banking Companies Act, 1949 ; 10 of 1949

(iii) in the case of a company engaged in the generation or supply of electricity, any matters which are required to be disclosed by [1][both the Indian Electricity Act, 1910, and the Electricity (Supply) Act, 1948] ; 9 of 1910 54 of 1948

(iv) in the case of a company governed by any other special Act for the time being in force, any matters which are not required to be disclosed by that special Act ; or

(v) in the case of any company, any matters which are not required to be disclosed by virtue of the provisions contained in Schedule VI or by virtue of a notification issued under sub-section (3) or an order issued under sub-section (4).

(6) For the purposes of this section, except where the context otherwise requires, any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by this Act, and allowed by this Act to be given in the form of such notes or documents.

(7) If any such person as is referred to in sub-section (6) of section 209 fails to take all reasonable steps to secure compliance by the company, as respects any accounts laid before the company in general meeting, with the provisions of this section and with the other requirements of this Act to the matters to be stated in the accounts, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both :

[1] Subs. by Act 65 of 1960, s. 62, for "the Electricity Supply Act, 1948 (54 of 1948).

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove [2][* * * that a competent and reliable person was charged with the duty of seeing that the provisions of this section and the other requirements aforesaid were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(*8*) If any person, not being a person referred to in sub-section (*6*) of section 209, having been charged by the managing agent, secretaries and treasurers, [1][managing,] or Board of directors, as the case may be, with the duty of seeing that the provisions of this section and the other requirements aforesaid are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months or with fine which may extend to one thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

Balance sheet of holding company to include certain particulars as to its subsidiaries

212. (*1*) There shall be attached to the balance sheet of a holding company having a subsidiary or subsidiaries at the end of the financial year as at which the holding company's balance sheet is made out, the following documents in respect of such subsidiary or of each such subsidiary, as the case may be :—

(*a*) a copy of the balance sheet of the subsidiary ;

(*b*) a copy of its profit and loss account ;

(*c*) a copy of the report of its Board of directors ;

[2] The words "that he had reasonable ground to believe and did believe" omitted by s. 62, *ibid.*

[1] Ins. by Act 65 of 1960, s. 62.

(*d*) a copy of the report of its auditors ;

(*e*) a statement of the holding company's interest in the subsidiary as specified in sub-section (*3*) ;

(*f*) the statement referred to in sub-section (5), if any ; and

(*g*) the report referred to in sub-section (*6*), if any.

(*2*) [2][(*a*) The balance sheet referred to in clause (*a*) of sub-section (*1*) shall be made out in accordance with the requirements of this Act,—

(*i*) as at the end of the financial year of the subsidiary, where such financial year coincides with the financial year of the holding company ;

(*ii*) as at the end of the financial year of the subsidiary last before that of the holding company where the financial year of the subsidiary does not coincide with that of the holding company ;]

(*b*) The profit and loss account and the reports of the Board of directors and of the auditors, referred to in clauses (*b*), (*c*) and (*d*) of sub-section (*1*), shall be made out, in accordance with the requirements of this Act, for the financial year of the subsidiary referred to in clause (*a*).

(*c*) [1][Where the financial year of the subsidiary does not coincide with that of the holding company, the financial year aforesaid] of the subsidiary shall not end on a day which precedes the day on which the holding company's financial year ends by more than six months.

(*d*) Where the financial year of a subsidiary is shorter in duration than that of its holding company, references to the financial year of the subsidiary in clauses (*a*), (*b*) and (*c*) shall be construed as references to two or more financial years

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[2] Subs. by s. 63, *ibid.*, for cl. (*a*).

[1] Subs. by Act 65 of 1960. s. 63, for "The financial year aforesaid".

of the subsidiary the duration of which, in the aggregate, is not less than the duration of the holding company's financial year.

(*3*) The statement referred to in clause (*e*) of sub-section (*1*) shall specify—

(*a*) the extent of the holding company's interest in the subsidiary at the end of the financial year or of the last of the financial years of the subsidiary referred to in sub-section (2) ;

(*b*) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiary's profits after deducting its losses or *vice versa*—

(*i*) for the financial year or years of the subsidiary aforesaid ; and

(*ii*) for the previous financial years of the subsidiary since it became the holding company's subsidiary ;

(*c*) the net aggregate amount of the profits of the subsidiary after deducting its losses or *vice versa*—

(*i*) for the financial year or years of the subsidiary aforesaid ; and

(*ii*) for the previous financial years of the subsidiary since it became the holding company's subsidiary ;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts.

(*4*) Clauses (*b*) and (*c*) of sub-section (*3*) shall apply only to profits and losses of the subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the

shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

(*a*) the company is itself the subsidiary of another body corporate ; and

(*b*) the shares were acquired from that body corporate or a subsidiary of it ;

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period, the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(*5*) Where the financial year or years of a subsidiary referred to in sub-section (*2*) do not coincide with the financial year of the holding company, a statement containing information on the following matters shall also be attached to the balance sheet of the holding company :—

(*a*) whether there has been any, and, if so, what change in the holding company's interest in the subsidiary between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year ;

(*b*) details of any material changes which have occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of—

(*i*) the subsidiary's fixed assets ;

(*ii*) its investments ;

(*iii*) the moneys lent by it ;

(*iv*) the moneys borrowed by it for any purpose other than that of meeting current liabilities.

(*6*) If, for any reason, the Board of directors of the holding company is unable to obtain information on any of the matters required to be specified by sub-section (*4*), a report in

writing to that effect shall be attached to the balance sheet of the holding company.

(*7*) The documents referred to in clauses (*e*), (*f*) and (*g*) of subsection (*1*) shall be signed by the persons by whom the balance sheet of the holding company is required to be signed.

(*8*) The Central Government may, on the application or with the consent of the Board of directors of the company, direct that in relation to any subsidiary, the provisions of this section shall not apply, or shall apply only to such extent as may be specified in the direction.

(*9*) If any such person as is referred to in sub-section (*6*) of section 209 fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both :

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove [1]* * * that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty :

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(*10*) If any person, not being a person referred to in sub-section (*6*) of section 209, having been charged by the managing agent, secretaries and treasurers, [2][managing director, manager,] or Board of directors, as the case may be, with the duty of seeing that the provisions of this section are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

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[1] The words "that he had reasonable ground to believe, and did believe," omitted by Act 65 of 1960, s. 63.

[2] Ins. by s. 63, *ibid.*

Financial year of holding company and subsidiary.

213. (*1*) Where it appears to the Central Government desirable for a holding company or a holding company's subsidiary, to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting, the Central Government may, on the application or with the consent of the Board of directors of the company whose financial year is to be extended, direct that in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return, shall not be required to be submitted, held or made, earlier than the dates specified in the direction, notwithstanding anything to the contrary in this Act or in any other Act for the time being in force.

(*2*) The Central Government shall, on the application of the Board of directors of a holding company or a holding company's subsidiary, exercise the powers conferred on that Government by sub-section (*1*) if it is necessary so to do, in order to secure that the end of the financial year of the subsidiary does not precede the end of the holding company's financial year by more than six months, where that is not the case at the commencement of this Act, or at the date on which the relationship of holding company and subsidiary comes into existence where that date is later than the commencement of this Act.

Right of holding company's representatives and members.

214. (*1*) A holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries; and the books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours.

(2) The rights conferred by section 235 upon members of a company may be exercised, in respect of any subsidiary, by members of the holding company as if they alone were members of the subsidiary.

Authentication of balance sheet and profit and loss account.

215. (1) Save as provided by sub-section (2), every balance sheet and every profit and loss account of a company shall be signed on behalf of the Board of directors—

(i) in the case of a banking company, by the persons specified in clause (a) or clause (b), as the case may be, of sub-section (2) of section 29 of the Banking Companies Act, 1949 ; 10 of 1949

(ii) in the case of any other company, by its managing agent, secretaries and treasurers, manager or secretary, if any, and by not less than two directors of the company one of whom shall be a managing director where there is one.

(2) In the case of a company not being a banking company, when only one of its directors is for the time being in India, the balance sheet and the profit and loss account shall be signed by such director ; but in such a case there shall be attached to the balance sheet and the profit and loss account a statement signed by him explaining the reason for non-compliance with the provisions of sub-section (1).

(3) The balance sheet and the profit and loss account shall be approved by the Board of directors before they are signed on behalf of the Board in accordance with the provisions of this section and before they are submitted to the auditors for their report thereon.

Profit and loss account to be annexed and auditors' report to be attached to balance sheet.

216. The profit and loss acount shall be annexed to the balance sheet and the auditors' report [1][(including the auditors' separate, special or supplementary report, if any)] shall be attached thereto.

[1] Ins. by Act 65 of 1960, s. 64.

Board's report.

217. (*1*) There shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of directors, with respect to—

(*a*) the state of the company's affairs ;

(*b*) the amounts, if any, which it proposes to carry to any reserves [2]* * * in such balance sheet [3]* * * ;

(*c*) the amount, if any, which it recommends should be paid by way of dividend :

[1][(*b*) material changes and commitments, if any ; affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report.]

(*2*) The Board's report shall, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the Board's opinion be harmful to the business of the company or of any of its subsidiaries, deal with any changes which have occurred during the financial year—

(*a*) in the nature of the company's business ;

(*b*) in the company's subsidiaries or in the nature of the business carried on by them ; and

(*c*) generally in the classes of business in which the company has an interest.

(*3*) The Board shall also be bound to give the fullest information and explanations in its report aforesaid, or in cases falling under the proviso to section 222, in an addendum to that report, on every reservation, qualification or adverse remark contained in the auditors' report.

(*4*) The Board's report and any addendum thereto shall be signed by its chairman if he is authorised in that behalf by the Board ; and where he is not so authorised, shall be signed by

[2] The word "either" omitted by s. 65, *ibid.*

[3] The words "or in a subsequent balance sheet ; and" omitted by s. 65, *ibid.*

[1] Ins. by Act 65 of 1960, s. 65.

such number of directors as are required to sign the balance sheet and the profit and loss account of the company by virtue of sub-sections (*1*) and (*2*) of section 215.

(*5*) If any person, being a director of a company, fails to take all reasonable steps to comply with the provisions of sub-sections (*1*) to (*3*), or being the chairman, signs the Board's report otherwise than in conformity with the provisions of sub-section (*4*), he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to two thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully :

Provided further that in any proceedings against a person in respect of an offence under sub-section (*1*), it shall be a defence to prove [1]* * * that a competent and reliable person was charged with the duty of seeing that the provisions of that sub-section were complied with and was in a position to discharge that duty.

(*6*) If any person, not being a director, having been charged by the Board of directors with the duty of seeing that the provisions of sub-sections (*1*) to (*3*) are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to two thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

Penalty for improper issue, circulation or publication of balance sheet or profit and loss account.

218. (*a*) If any copy of a balance sheet or profit and loss account which has not been signed as required by section 215 is issued, circulated or published ; or

(*b*) If any copy of a balance sheet is issued, circulated or published without there being annexed or attached thereto, as the case may be, a copy each of (*i*) the profit

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[1] The words "that he had reasonable ground to believe, and did believe," omitted by Act 65 of 1960, s. 65.

and loss account, (*ii*) any accounts, reports or statements which, by virtue of section 212, are required to be attached to the balance sheet, (*iii*) the auditors' report, and (*iv*) the Board's report referred to in section 217 ; the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

Right of member to copies of balance sheet and auditor's report.

219. (*1*) A copy of every balance sheet (including the profit and loss account, the auditors' report and every other document required by law to be annexed or attached, as the case may be, to the balance sheet) which is to be laid before a company in general meeting shall, not less than twenty-one days before the date of the meeting, be sent to every member of the company, to every holder of debentures issued by the company (not being debentures which *exfacie* are payable to the bearer thereof), to every trustee for the holders of any debentures issued by the company, whether such member, holder or trustee is or is not entitled to have notices of general meetings of the company sent to him, and to all persons other than such members, holders or trustees, being persons so entitled.

Provided that—

(*a*) in the case of a company not having a share capital, this sub-section shall not require the sending of a copy of the documents aforesaid to a member, or holder of debentures, of the company who is not entitled to have notices of general meetings of the company sent to him ;

(*b*) this sub-section shall not require a copy of the documents aforesaid to be sent—

(*i*) to a member, or holder of debentures, of the company, who is not entitled to have notices of general meetings of the company sent to him and of whose address the company is unaware ;

(*ii*) to more than one of the joint holders of any shares or debentures none of whom is entitled to have such notices sent to him ; or

(*iii*) in the case of joint holders of any shares or debentures some of whom are and some of whom are not entitled to have such notices sent to them, to those who are not so entitled ; and

(*c*) if the copies of the documents aforesaid are sent less than twenty-one days before the date of the meeting, they shall, notwithstanding that fact, be deemed to have been duly sent if it is so agreed by all the members entitled to vote at the meeting.

(*2*) Any member or holder of debentures of a company, whether he is or is not entitled to have copies of the company's balance sheet sent to him shall, on demand, be entitled to be furnished without charge, and any person from whom the company has accepted a sum of money by way of deposit shall, on demand accompanied by the payment of a fee of one rupee, be entitled to be furnished, with a copy of the last balance sheet of the company and of every document required by law to be annexed or attached thereto, including the profit and loss account and the auditors' report.

(*3*) If default is made in complying with sub-section (*1*), the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

(*4*) If, when any person makes a demand for a copy of any document with which he is entitled to be furnished by virtue of sub-section (*2*), default is made in complying with the demand within seven days after the making thereof, the company, and every officer of the company who is in default, shall be punishable

with fine which may extend to five hundred rupees, unless it is proved that that person had already made a demand for and been furnishd with a copy of the document.

The Court may also, by order, direct that the copy demanded shall forthwith be furnished to the person concerned.

(*5*) Sub-sections (*1*) to (*4*) shall not apply in relation to a balance sheet of a private company laid before it before the commencement of this Act ; and in such a case the right of any person to have sent to him or to be furnished with a copy of the balance sheet, and the liability of the company in respect of a failure to satisfy that right, shall be the same as they would have been if this Act had not been passed.

Three copies of balance sheet, etc., to be filed with Registrar.

220. (*1*) After the balance sheet and the profit and loss account have been laid before a company at an annual general meeting as aforesaid, there shall be filed with the Registrar at the same time as the copy of the annual return referred to in section 161—

(*a*) [1]* * * three copies of the balance sheet and the profit and loss account, signed by the managing director, managing agent, secretaries and treasurers, manager or secretary of the company, or if there be none of these, by a director of the company, together with three copies of all documents which are required by this Act to be annexed or attached to such balance sheet or profit and loss account :

[2][Provided that in the case of a private company, copies of the balance sheet and copies of the profit and loss account shall be filed with the Registrar separately :]

[3]* * * * * *

[2][Provided further that,—

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[1] The words "in the case of a public company" omitted by Act 65 of 1960, s. 66.

[2] Ins. by s. 66, *ibid.*

[3] Cl. (*b*) omitted by s. 66, *ibid.*

(*i*) in the case of a private company which is not a subsidiary of a public company, or

(*ii*) in the case of a private company of which the entire paid-up share capital is held by one or more bodies corporate incorporated outside India, or

(*iii*) in the case of a company which becomes a public company by virtue of section 43A, if the Central Government directs that it is not in the public interest that any person other than a member of the company shall be entitled to inspect, or obtain copies of, the profit and loss account of the company,

no person other than a member of the company concerned shall be entitled to inspect, or obtain copies of, the profit and loss account of that company under section 610.]

(*2*) If the annual general meeting of a [1]* * company before which a balance sheet is laid as aforesaid does not adopt the balance sheet, a statement of that fact and of the reasons therefor shall be annexed to the balance sheet and to the copies therof required to be filed with the Registrar.

(*3*) If default is made in complying with the requirements of sub-sections (*1*) and (*2*), the company, and every officer of the company who is in default, shall be liable to the like punishment as is provided by section 162 for a default in complying with the provisions of sections 159,160 or 161.

Duty of officer to make disclosure of payments, etc.

221. (*1*) Where any particulars or information is required to be given in the balance sheet or profit and loss account of a company or in any document required to be annexed or attached thereto, it shall be the duty of the concerned officer of the company to furnish without delay to the company, and also to the company's auditor whenever he so requires, those particulars or that information in as full a manner as possible.

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[1] The words "public or private" omitted by Act 65 of 1960, s. 66.

(2) Where the officer concerned is a firm or body corporate acting as managing agent or as secretaries and treasurers, the duty aforesaid shall extend to every partner in the firm, or to every director of the body corporate, as the case may be.

(3) The particulars or information referred to in sub-section (1) may relate to payments made to any director, managing agent, secretaries and treasurers, or other person by any other company, body corporate, firm or person.

(4) If any person knowingly makes default in performing the duty cast on him by the foregoing provisions of this section, he shall be punishable with imprisonment which may extend to six months, or with fine which may extend to five thousand rupees, or with both.

Construction of references to documents annexed to accounts

222. References in this Act to documents annexed or required to be annexed to a company's accounts or any of them shall not include the Board's report, the auditors' report or any document attached or required to be attached to those accounts :

Provided that any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts ; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as it gives the said information.

Certain companies to publish statement in the Form in Table F in Schedule I.

223. (1) Every company which is a limited banking company, an insurance company, or a deposit, provident or benefit society, shall, before it commences business and also on the first Monday in February and the first Monday in August in every year during which it carries on business, make a statement in the Form in Table F in Schedule I, or in a Form as near thereto as circumstances admit.

(2) A copy of the statement, together with a copy of the last audited balance sheet laid before the members of the company, shall be displayed and until the display of the next following statement, shall be kept displayed, in a conspicuous place in the registered office of the company, and in every branch office or place where the business of the company is carried on.

(3) Every member, and every creditor, of the company shall be entitled, on payment of a sum of eight annas, to be furnished with a copy of the statement, within seven days of such payment.

(4) If default is made in complying with any of the requirements of this section, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to fifty rupees for every day during which the default continues.

(5) This section shall not apply to a life assurance company or provident insurance society to which the provisions of the Insurance Act, 1938, as to the annual statements to be made by such company or society, apply with or without modifications, if the company or society complies with those provisions.

Audit

Appointment and remuneration of auditors.

224. [1][(*1*) Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed, unless he is a retiring auditor.

(*1A*) Every auditor appointed under sub-section (*1*), unless he is a retiring auditor, shall within thirty days of the receipt from the company of the intimation of his appointment, inform

[1] Subs. by Act 65 of 1960, s. 67, for sub-section (*1*).

the Registrar in writing that he has accepted, or refused to accept, the appointment.]

(*2*) At any annual general meeting, a retiring auditor, by whatsoever authority appointed, shall be re-appointed, unless—

(*a*) he is not qualified for re-appointment ;

(*b*) he has given the company notice in writing of his unwillingness to be re-appointed ;

(c) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed ; or

(*d*) where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with.

(*3*) Where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy.

(*4*) The company shall, within seven days of the Central Government's power under sub-section(*3*), becoming exercisable, give notice of that fact to that Government ; and, if a company fails to give such notice, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

(*5*) The first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company ; and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting :

Provided that—

(*a*) the company may, at a general meeting, remove any such auditor or all or any of such auditors and appoint in his or their places any other person or

persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting ; and

(*b*) if the Board fails to exercise its powers under this sub-section, the company in general meeting may appoint the first auditor or auditors.

(*6*) (*a*) The Board may fill any casual vacancy in the office of an auditor ; but while any such vacancy continues, the remaining auditor or auditors, if any, may act :

Provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in general meeting.

(*b*) Any auditor appointed in a casual vacancy shall hold office until the conclusion of the next annual general meeting.

(*7*) Except as provided in the proviso to sub-section (*5*), any auditor appointed under this section may be removed from office before the expiry of his term only by the company in general meeting, after obtaining the previous approval of the Central Government in that behalf.

(*8*) The remuneration of the auditors of a company—

(*a*) in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be ; and

(*b*) subject to clause (*a*), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For the purposes of this sub-section, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration".

Provisions as to resolutions for appointing or removing auditors

225. (*1*) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed.

(*2*) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

(*3*) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representations in writing to the company (not exceeding a reasonable length) and requests their notification to members of the company, the company shall, unless the representations are received by it too late for it to do so,—

(*a*) in any notice of the resolution given to members of the company, state the fact of the representations having been made ; and

(*b*) send a copy of the representations to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representations by the company ;

and if a copy of the representations is not sent as aforesaid because they were received too late or because of the company's default the auditor may (without prejudice to his right to be heard orally) require that the representations shall be read out at the meeting :

Provided that copies of the representations need not be sent out and the representations need not be read out at the meeting if, on the application either of the company or of any other person who claims to be aggrieved, the Court is satisfied that the rights conferred by this sub-section are being abused to secure needless publicity for defamatory matter ; and the Court may order the company's costs on such an application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application.

(*4*) Sub-sections (*2*) and (*3*) shall apply to a resolution to remove the first auditors or any of them under sub-section (*5*) of section 224 or to the removal of any auditor or auditors under sub-section (*7*) of that section, as they apply in relation to a resolution that a retiring auditor shall not be re-appointed.

Qualifications and disqualifications of auditors

226. (*1*) A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949 :

Provided that a firm whereof all the partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company, in which case any partner so practising may act in the name of the firm.

(*2*) (*a*) Notwithstanding anything contained in sub-section (*1*), but subject to the provisions of any rules made under clause (*b*), the holder of a certificate granted under a law in force in the whole or any portion of a Part B State immediately before the commencement of the Part B States (Laws) Act, 1951 [1][or of the Jammu and Kashmir (Extension of Laws) Act, 1956, as the case may be,] entitling him to act as an auditor of companies [2][in the territories which, immediately before the 1st November, 1956, were comprised in that State] or any portion thereof, shall be entitled to be appointed to act as an auditor of companies registered anywhere in [3][India].

(*b*) The Central Government may, by notification in the Official Gazette, make rules providing for the grant, renewal, suspension or cancellation of auditors' certificates to persons in [4][the territories which, immediately before the 1st November, 1956, were comprised in Part B States] for the purposes of clause (*a*), and prescribing conditions and restrictions for such grant, renewal, suspension or cancellation.

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[1] Ins. by Act 62 of 1956, s. 2 and Sch. (w.e.f. 1-11-1956).

[2] Subs. by the A. O. (No. 3) 1956, for "in that State".

[3] Subs. by Act 65 of 1960, s. 68, for "those territories".

[4] Subs. by the A. O. (No. 3) 1956, for "Part B States".

(3) None of the following persons shall be qualified for appointment as auditor of a company—

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees;

(e) a person who is a director or member of a private company, or a partner of a firm, which is the managing agent or the secretaries and treasurers of the company;

(f) a person who is a director, or the holder of shares exceeding five per cent. in nominal value of the subscribed capital, of any body corporate which is the managing agent or the secretaries and treasurers, of the company:

Provided that any shares held by such person as nominee or trustee for any third person and in which the holder has no beneficial interest shall be excluded in computing the percentage of shares held by him for the purpose of this clause.

Explanation.—References in this sub-section to an officer or employee shall be construed as not including references to an auditor.

(4) A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub-section (3), disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.

(*5*) If an auditor becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (*3*) and (*4*), he shall be deemed to have vacated his office as such.

Powers and duties of auditors

227. (*1*) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere, and shall be entitled to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his duties as auditor.

(*2*) The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance sheet or profit and loss account, which are laid before the company in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

(*i*) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year ; and

(*ii*) in the case of the profit and loss account, of the profit or loss for its financial year.

(*3*) The auditor's report shall also state—

(*a*) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit ;

(*b*) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him ;

[1][(*bb*) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (*c*) of sub-section (*3*) of that section and how he has dealt with the same in preparing the auditor's report ;]

(*c*) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(*4*) Where any of the matters referred to in clauses (*i*) and (*ii*) of sub-section (*2*) or in clauses (*a*), (*b*), [1][(*bb*)] and (*c*) of sub-section (*3*) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

[2][(*5*) The accounts of a company shall not be deemed as not having been, and the auditor's report shall not state that those accounts have not been, properly drawn up on the ground merely that the company has not disclosed certain matters if—

(*a*) those matters are such as the company is not required to disclose by virtue of any provisions contained in this or any other Act, and

(*b*) those provisions are specified in the balance sheet and profit and loss account of the company.]

Audit of accounts of branch office of company

228. (*1*) Where a company has a branch office, the accounts of that office shall, [3][be audited by the company's auditor appointed under section 224 or] by a person qualified for appointment as auditor of the company under section 226, or where the branch office is situate in a country outside India, either [1][by the company's auditor or a person qualified as aforesaid] or by an accountant duly qualified to act as an auditor

[1] Ins. by Act 65 of 1960, s. 69.
[2] Subs. by s. 69, *ibid.*, for sub-section (5).
[3] Subs. by s. 70, *ibid.*, for certain words.
[1] Subs. by Act 65 of 1960, s. 70, for "by a person qualified as aforesaid".

of the accounts of the branch office in accordance with the laws of that country.

(2) Where the accounts of any branch office are [2][audited by a person other than the company's auditor] the company's auditor—

(a) shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

(b) shall have a right of access at all times to the books and accounts and vouchers of the company maintained at the branch office :

Provided that in the case of a banking company having a branch office outside India, it shall be sufficient if the auditor is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company in India.

[3][(3) (a) Where a company in general meeting decides to have the accounts of a branch office audited otherwise than by the company's auditor, the company in that meeting shall for the audit of those accounts appoint a person qualified for appointment as auditor of the company under section 226, or where the branch office is situate in a country outside India, a person who is either qualified as aforesaid or an accountant duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country, or authorise the Board of directors to appoint such a person in consultation with the company's auditor ;

(b) the person so appointed (hereafter in this section referred to as the branch auditor) shall have the same powers and duties in respect of audit of the accounts of the branch office as the company's auditor has in respect of the same ;

(c) the branch auditor shall prepare a report on the accounts of the branch office examined by him and forward the

[2] Subs. by s. 70, *ibid.*, for "not so audited".
[3] Ins. by s. 70, *ibid.*

same to the company's auditor who shall in preparing the auditor's report, deal with the same in such manner as he considers necessary ;

(*d*) the branch auditor shall receive such remuneration and shall hold his appointment subject to such terms and conditions as may be fixed either by the company in general meeting or by the Board of directors if so authorised by the company in general meeting.

(*4*) Notwithstanding anything contained in the foregoing provisions of this section, the Central Government may, by rules made in this behalf, exempt any branch office from the provisions of this section to the extent specified in the rules and in making such rules the Central Government shall have regard to all or any of the following matters, namely :—

(*a*) the arrangement made by the company for the audit of accounts of the branch office by a person otherwise qualified for appointment as branch auditor even though such person may be an officer or employee of the company ;

(*b*) the nature and quantum of activity carried on at the branch office during a period of three years immediately preceding the date on which the branch office is exempted from the provisions of this section ;

(*c*) the availability at a reasonable cost of a branch auditor for the audit of accounts of the branch office ;

(*d*) any other matter which in the opinion of the Central Government justifies the grant of exemption to the branch office from the provisions of this section.]

Signature of audit report, etc.

229. Only the person appointed as auditor of the company, or where a firm is so appointed in pursuance of the proviso to sub-section (*1*) of section 226, only a partner in the firm practising in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor

Reading and inspection of auditor's report

230. *The auditor's report shall be read* before the company *in general meeting and* shall be open to inspection by any member of the company.

Right of auditor to attend general meeting

231. All notices of, and other communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him shall also be forwarded to the auditor of the company ; and the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor.

Penalty for non-compliance with sections 225 to 231

232. If default is made by a company in complying with any of the provisions contained in sections 225 to 231, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

Penalty for non-compliance by auditor with sections 227 and 229

233. If any auditor's report is made, or any document of the company is signed or authenticated, otherwise than in conformity with the requirements of sections 227 and 229, the auditor concerned, and the person, if any, other than the auditor who signs the report or signs or authenticates the document, shall, if the default is wilful, be punishable with fine which may extend to one thousand rupees.

Power of Central Government to direct special audit in certain cases

[1][**233A.** (*1*) Where the Central Government is of the opinion—

(*a*) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices ; or

[1] Ins. by Act 65 of 1960, s. 71.

(*b*) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains ; or

(*c*) that the financial position of any company is such as to endanger its solvency ; the Central Government may at any time by order direct that a special audit of the company's accounts for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant as defined in clause (*b*) of sub-section (*1*) of section 2 of the Chartered Accountants Act, 1949, (whether or not such chartered accountant is a chartered accountant in practice within the meaning of that Act) or the company's auditor himself to conduct such special audit.

(*2*) The chartered accountant or the company's auditor appointed under sub-section (*1*) to conduct a special audit as aforesaid is hereafter in this section referred to as the special auditor.

(*3*) The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a company has under section 227 :

Provided that the special auditor shall, instead of making his report to the members of the company, make the same to the Central Government.

(*4*) The report of the special auditor shall, as far as may be, include all the matters required to be included in an auditor's report under section 227 and, if the Central Government so directs, shall also include a statement on any other matter which may be referred to him by that Government.

(*5*) The Central Government may by order direct any person specified in the order to furnish to the special auditor within such time as may be specified therein such information or additional information as may be required by the special auditor in connection with the special audit; and on failure to comply with such order such person shall be punishable with fine which may extend to five hundred rupees.

(*6*) On receipt of the report of the special auditor, the Central Government may take such action on the report as it considers necessary in accordance with the provisions of this Act or any other law for the time being in force :

Provided that if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the company either a copy of, or relevant extract from, the report with its comments thereon and require the company either to circulate that copy or those extracts to the members or to have such copy or extracts read before the company at its next general meeting.

(*7*) The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government (which determination shall be final) and paid by the company and in default of such payment shall be recoverable from the company as an arrear of land revenue.]

Appendix B

FORM OF COMPANY BALANCE-SHEET AS SHOWN IN SCHEDULE VI, PART 1 OF THE COMPANIES ACT, 1956 (AS MODIFIED UP TO 1st. MAY' 1961) [*See* section 211]

Balance-Sheet of............(Here enter the name of the company)

As at................(Here enter the date as at which the balance-sheet is made out)

Instructions in accordance with which liabilities should be made out	Figures for the previous year	Liabilities	Figures for the current year	Figures for the previous year	Assets	Figures for the current year	Instructions in accordance with which assets should be made out
	Rs. (*b*)		Rs. (*b*)	Rs. (*b*)		Rs. (*b*)	
*Terms of redemption or conversion (if any) of any redeemable preference capital to be stated, together with earliest date of redemption or conversion. Particulars of any option on unissued share capital to be specified.		*SHARE CAPITAL : Authorised......shares of Rs.........each. †Issued (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)......			*FIXED ASSETS : Distinguishing as far as possible between expenditure upon (*a*) good-will, (*b*) land, (*c*) buildings, (*d*) leaseholds, (*e*) railway sidings, (*f*) plant and machinery, (*g*) furniture and		*Under each head the original cost, and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year to be stated. 3[In every case where the original cost cannot be ascertained, without unreasonable expense

†Particulars of the different classes of preference shares . . iven.	shares of Rs....each. †Subscribed (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class.) (c).......shares of Rs.........each. Rs......... called up. Of the above shares,... shares are allotted as fully paid up pursuant to a contract without payments being received in cash.	fittings, (h) development of property, (i) patents, trade marks and designs, (j) live-stock and (k) vehicles, etc.	or delay, the valuation shown by the books shall be given. For the purposes of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sales proceeds shall be shown as deduction.]
2[*Specify the source from which bonus shares are issued, *e.g.*, capitalisation of profits or Reserves or from Share Premium Account.]	3[Of the above shares .....shares are allotted as fully paid up by way of bonus shares*.]		
	Less : Calls unpaid : (i) By managing agent or secretaries and treasurers and where the managing agent or secretaries and treasurers are a firm,		Where sums have been written off on a reduction of capital or a revaluation of assets, every balance-sheet, (after the first balance-sheet) subsequent to

	by the partners thereof, and where the managing agent or secretaries and treasurers are a private company, by the directors or members of that company.		the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost.
	(*ii*) By director-.		Each balance-sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the of the reduction made.
	(*iii*) By others.		
[2][†Any capital profit on re-issue of forfeited shares should be transferred to Capital Reserve.]	[3][†*Add* : Forfeited shares (amount originally paid up.)]		Similarly, where sums have been added by writing up the assets, every balance-sheet subsequent to such writing up shall show the increased figures with the

[1] Subs. by Act 65 of 1960, s. 217, for the original Part I.

[2] Ins. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.

[3] Subs., *ibid*.

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs. (b)		Rs. (b)	Rs. (b)		Rs. (b)	date of the increase in place of the original cost. Each balance-sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made.
		*RESERVES AND SURPLUS:			INVESTMENTS:		
*Additions and deductions since last balance-sheet to be shown, under each of the specified heads.		1[(1) Capital Reserves. (2) Capital Redemption Reserve. (3) Share Premium Account (cc).			Showing nature of investments and mode of valuation, for example cost or market value and distinguishing between—		*Aggregate amount of company's quoted investments and also the market value thereof shall be shown.
1[The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by ear-marked investments.]		(4) Other Reserves specifying the nature of each Reserve and the amount in respect thereof.			*(1) Investments in Government or Trust Securities.		Aggregate amount of company's unquoted investments shall also be shown.
		Less : Debit balance in profit and loss account (if any) (h).			*(2) Investments in shares, debentures or bonds (showing separately shares, fully paid up and partly paid up and also distinguishing the different classes of		

	(5) Surplus, *i.e.*. balance in profit and loss account after providing for proposed allocations, namely :	shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies.	
	Dividend, Bonus or Reserves.	Immovable properties.	
	(6) Proposed additions to Reserves.		
	(7) Sinking Funds.]		
	SECURED LOANS :	CURRENT ASSETS, LOANS AND ADVANCES :	
2[*Loans from Directors, the Managing Agents, Secretaries and Treasurers, Manager should be shown separately. Interest accrued and due on Secured Loans should be included under the appropriate sub-heads under the head "SECURED LOANS".] *The nature of the security to be specified in each case.	*(1) Debentures† *(2) Loans and Advances from Banks. *(3) Loans and Advances from subsidiaries. *(4) Other Loans and Advances.	(A) CURRENT ASSETS (1) Interest accrued on Investments. ††(2) Stores and spare parts. 1[(3) Loose Tools.] ††(4) Stock-in-trade. ††(5) Works in Progress. †(6) Sundry debtors.	††Mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable. **Mode of valuation of works in progress shall be stated. †In regard to Sundry Debtors particulars to be given separately of—(*a*) debts considered good and in respect of which the company is fully secured ; and (*b*) debts considered good for which the company holds

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Where loans have been guaranteed by managing agents, secretaries and treasurers, managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head. †Terms of redemption or conversion (if any) of debentures issued to be stated together with earliest date of redemption or conversion.		(a) Debts outstanding for a period exceeding six months.	no security other than the debtor's personal security; and (c) debts considered doubtful or bad.
		(b) Other debts.	Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated.
		[1][*Less* : Provision]	
		[2](7) Cash and bank balances.	

[1] Subs. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*) p. 117.

[2] Ins. *ibid.*

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs. (b)	Rs. (b)	Rs. (b)	Rs. (b)	Debts due from other companies under the same management to be disclosed with the names of the companies (*vide* section 370). The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note. The [2][Provision] to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such [2][Provision], if already created, should be shown at every closing under "Reserves and Surplus" (in the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts". †The balances lying with bankers on current accounts, call accounts and deposit accounts shall be shown separately.

	UNSECURED LOANS :		
[1][†Loans from Directors, the Managing Agents, Secretaries and Treasurers, Manager should be shown separately.	(1) Fixed Deposits. †(2) Loans and Advances from subsidiaries. †*(3) Short Term Loans and Advances : (*a*) From Banks. (*b*) From others.		
Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "UNSECURED LOANS"].	†(4) Other Loans and Advances : (*a*) From Banks. (*b*) From others.		
†Where loans have been guaranteed by managing agents, secretaries and treasurers, managers, and †or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.	**CURRENT LIABILITIES AND PROVISIONS** A. CURRENT LIABILITIES. [2][(1) Acceptances.	†(B) LOANS AND ADVANCES.	
*See note (*d*) at foot of Form.	(2) Sundry Creditors.	(8) Advances and Loans to subsidiaries.	
	(3) Subsidiary Companies.	(9) Bills of Exchange.	†The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also.
	(4) Advance payments and unexpired discounts for the	(10) Advances recoverable in cash or in kind or for value to	

[1] Ins. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.
[2] Subs., *ibid*.

Instructions in accordance with which liabilities should be made out	Liabilities: Figures for the previous year	Liabilities	Liabilities: Figures for the current year	Assets: Figures for the previous year	Assets	Assets: Figures for the current year	Instructions in accordance with which assets should be made out
	Rs. (b)	portion for which value has still to be given, *e.g.*, in the case of the following classes of companies :— Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc. (5) Unclaimed Dividends. (6) Other Liabilities (if any). (7) Interest accrued but not due on loans.] B. PROVISIONS. [1] [(8) Provision for Taxation.	Rs. (b)	Rs. (b)	be received, *e.g.*, Rates, Taxes, Insurance, etc. (11) Balances on current account with Managing Agents or Secretaries and Treasurers. (12) Balances with Customs, Port Trust, etc. (where payable on demand).	Rs. (b)	

	(9) Proposed Dividends. (10) For contingencies. (11) For Provident Fund scheme. (12) For insurance, pension and similar staff benefit schemes. (13) Other provisions.]		
††The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated.	[A foot-note to the balance-sheet may be added to show separately :— (1) Claims against the company not acknowledged as debts. (2) Uncalled liability on shares partly paid. ††(3) Arrears of fixed cumulative dividends.		
The amount shall be stated before deduction of Income-tax, except that in the case of tax-free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated.	(4) Estimated amount of contracts remaining to be executed on capital account and not provided for. †(5) Other money for which the com-	MISCELLANEOUS EXPENDITURE (to the extent not writ-	

[1] Subs. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, see Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.
[2] Ins., *ibid.*

Instructions in accordance with which liabilities should be made out	LIABILITIES: Figures for the previous year	LIABILITIES: Figures for the current year	ASSETS: Figures for the previous year	ASSETS: Figures for the current year	Instructions in accordance with which assets should be made out
†The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified.	Rs. (b)	Rs. (b) pany is contingently liable.]	Rs. (b) ten off [2][or adjusted]): (1) Preliminary expenses. (2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures. (3) Discount allowed on the issue of shares or debentures. (4) Interest paid out of capital during construction (also stating the rate of interest). (5) Development expenditure not adjusted. (6) Other items (specifying nature). [1][†PROFIT AND LOSS ACCOUNT]	Rs. (b)	[2][†Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any.]

NOTES

General instructions for preparation of balance-sheet.—(*a*) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance-sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance-sheet. This is recommended when items are numerous.

(*b*) Naye Paise can also be given in addition to Rupees, if desired.

(*c*) In the case of [1][subsidiary companies] the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

The auditor is not required to certify the correctness of such share-holdings as certified by the management.

[1][(*cc*) The item "Share Premium Account" shall include details of its utilisation in the manner provided in section 78 in the year of utilisation.]

(*d*) Short Term Loans will include those which are due for not more than one year as at the date of the balance-sheet.

(*e*) Depreciation written off or provided shall be allocated under the different asset heads and deducted in arriving at the value of Fixed Assets.

(*f*) Dividends declared by subsidiary companies after the date of the balance-sheet [[1]should not be included] unless they are in respect of period which closed on or before the date of the balance-sheet.

(*g*) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance-sheet but shall be made in the Board's report.

[1][(*h*) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.]

(*i*) As regards Loans and Advances, amounts due by the Managing Agents or Secretaries and Treasurers, either severally or jointly with any other persons, to be separately stated; the amounts due from other companies under the same management should also be given with the names of the companies *vide* section 370; the maximum amount due from every one of these at any time during the year must be shown.

(*j*) Particulars of any redeemed debentures which the company has power to issue snould be given.

(*k*) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

(*l*) A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balnace-sheet showing the names of the bodies corporate, indicating separately the names of the bodies corporate in the same group (with the name of the managing agent or secretaries and treasurers, if any, of every body corporate) in whose shares or debentures investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance-sheet was made out) and the nature and extent of the investments so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock,

debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance-sheet has been made out; provided further that it shall not be necessary to give any particulars in respect of investments made by a managing agency or secretaries and treasurers company in the managed companies' shares or debentures.

A "Trade Investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary for the purpose of promoting the trade or business of the first company.

(*m*) If, in the opinion of the Board, any of the [1][current assets, loans and advances] have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

(*n*) Except in the case of the first balance-sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance-sheet shall be also given in the balance-sheet. The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance-sheet for the corresponding date in the previous year.

(*o*) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

[1][(*p*) Current accounts with Directors, Managing Agents, Secretaries and Treasurers and Manager, whether they are in credit or debit, shall be shown separately.]

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[1] Subs. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.

[2] Ins. *ibid*

Appendix C

REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT AS GIVEN UNDER SCHEDULE VI, PART II OF THE COMPANIES ACT, 1956 (AS MODIFIED UP TO 1st. MAY, 1961)

PART II.—REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section *(2)* of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.

2. The profit and loss account—

(*a*) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account ; and

(*b*) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads ; and in particular, shall disclose the following information in respect of the period covered by the account :—

(*i*) (*a*) The turnover, that is, the aggregate amount for which sales are effected by the company.

[1][(*b*) Commission paid to sole selling agents within the meaning of section 294 of the Act

(*c*) Commission paid to other selling agents.

(*d*) Brokerage and discount on sales, other than the usual trade discount.]

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[1] Subs. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.

(*ii*) (*a*) In the case of manufacturing concerns, the purchases of raw material, and the opening and the closing stocks of the goods produced.

(*b*) In the case of trading concerns, the purchases made, and the opening and the closing stocks.

(*c*) In the case of concerns rendering or supplying services, the gross income derived from services rendered or supplied.

[1][(*d*) In the case of a concern which falls under more than one of the categories mentioned under clauses (*a*), (*b*) and (*c*) above, it shall be sufficient compliance of the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases and sales and the gross income from services rendered is shown.

(*e*) In the case of other concerns, the gross income derived under the different heads.]

(*iii*) In the case of all concerns having works in progress, the amounts for which [1][such works have been completed] at the commencement and at the end of the accounting period.

(*iv*) The amount provided for depreciation, renewals or diminution in value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated [2][and the quantum of arrears of depreciation computed in accordance with section 205 (*2*) of the Act shall be disclosed by way of a note].

[1] Subs. by Act 65 of 1960, s. 217, for "works remained to be executed".
[2] Ins. by Notifn. No. G.S.R. 414, dated the 21st March, 1961, *see* Gazette of India, *Extraordinary*, Pt. II, Sec. 3(*i*), p. 117.

(*v*) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, [3][paid or payable] to the managing director, the managing agent, the secretaries and treasurers and the manager, if any.

(*vi*) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(*vii*) The [4][amounts reserved for]—

(*a*) repayment of share capital ; and

(*b*) repayment of loans.

(*viii*) (*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance-sheet is made up.

(*b*) The aggregate, if material, of any amounts withdrawn from such reserves.

(*ix*) (*a*) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(*x*) Expenditure incurred on each of the following items, separately for each item :—

(*a*) Consumption of stores and spare parts.

(*b*) Power and fuel.

(*c*) Rent.

(*d*) Repairs to buildings.

(*e*) Repairs to machinery.

(*f*) (*1*) Salaries, wages and bonus.

(2) Contribution to provident and other funds.

(3) Workmen and staff welfare expenses [1][to the extent not adjusted from any previous provision or reserve.

Note.—Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account].

(*g*) Insurance.

(*h*) Rates and taxes, excluding taxes on income.

(*i*) Miscellaneous expenses.

(*xi*) (*a*) The amount of income from investments, distinguishing between trade investments and other investments.

(*b*) Other income by way of interest, specifying the nature of the income.

(*c*) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (*a*) and (*b*) above.

(*xii*) (*a*) Profits or losses on investments [1][to the extent not adjusted from any previous provision or reserve.

Note.—Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account].

(*b*) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

(c) Miscellaneous income.

(*xiii*) (*a*) Dividends from subsidiary companies.

(*b*) Provisions for losses of subsidiary companies.

(*xiv*) The aggregate amount of the dividends paid and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

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[1] Ins. by Act 65 of 1960, s. 217.

(*xv*) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

[1][4. [2][The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors), the managing agents, secretaries and treasurers or manager, if any, by the company, the subsidiaries of the company and any other person :—]

(*i*) [2][managerial remuneration under section 198 of the Act paid or payable] during the financial year to the directors (including managing directors), the managing agent, secretaries and treasurers or manager, if any ;

(*ii*) expenses reimbursed to the managing agent under section 354 ;

(*iii*) commission or other remuneration payable separately to a managing agent or his associate under sections 356, 357 and 358 ;

[2][(*iv*) commission received or receivable under section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company ;]

(*v*) the money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under section 360 during the financial year ;

[2][(*vi*) other allowances and commission including guarantee commission (details to be given) ;]

(*vii*) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable) ;

(*viii*) pensions, etc.,—

(*a*) pensions,

(*b*) gratuities,

(*c*) payments from provident funds, in excess of own subscriptions and interest thereon,

(*d*) compensation for loss of office,

(*e*) consideration in connection with retirement from office.

[1][**4A.** The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors), the managing agents, secretaries and treasurers or manager (if any).]

[2][**4B.**] The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, or otherwise for services rendered—

(*a*) as auditor ; and

(*b*) in any other capacity.]

5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (*1*) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(*2*) The requirement in sub-clause (*1*) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year.

APPENDIX D

BALANCE SHEET

(WITH SCHEDULES)

AND

PROFIT & LOSS ACCOUNT

OF A RENOWNED JOINT STOCK COMPANY

NATIONAL RUBBER

BALANCE SHEET AS AT

LIABILITIES

Rs.		Rs
	Share Capital	
59,94,953	As per Schedule 'A'	60,00,000
	Reserves & Surplus	
12,74,759	As per Schedule 'B'	15,64,606
	Secured Loans	
96,11,985	As per Schedule 'C'	1,23,98,422
	Unsecured Loans	
3,01,461	As per Schedule 'D'	21,61,987
	Current Liabilities and Provisions	
39,72,829	As per Schedule 'E'	43,39,192
	Notes : (i) Bills discounted with the bankers for Rs. 5,28,906/- which were not realised by the Bankers as on 31st December, 1961 from the parties on whom the bills were drawn. (ii) Unredeemed Guarantee given to Bankers Rs. 4,63,212/-. (iii) Guarantee given as Managing Agents of General Tyres Ltd. to Industrial Finance Corporation of India Rs. 1,00,00,000/-.	
2,11,55,987		2,64,64,207

TO THE SHAREHOLDERS OF NATIONAL RUBBER MANUFACTURERS LTD.

We report that we have audited the above Balance Sheet and its annexed Profit and Loss Account and, in our opinion and to the best of our information and according to the explanations given to us, the above Balance Sheet and its annexed Profit and Loss Account, read in conjunction with the Notes appearing on Profit and Loss Account and Schedule 'A' give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 31st December, 1956, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion proper books of account have been kept as required by law as far as appears from our examination of the books and the above mentioned accounts are in agreement therewith.

CALCUTTA,
6, Hastings Street
The 28th February 1956

G. BASU & CO.
Chartered Accountants.

MANUFACTURERS LIMITED

31ST DECEMBER

ASSETS

Rs.		Rs.
	Fixed Assets	
66,35,302	As per Schedule 'F'	69,57,402
	Investments	
8,450	As per Schedule 'G'	8,450
	Current Assets, Loans and Advances	
1,43,60,894	As per Schedule 'H'	1,93,47,014
	Miscellaneous Expenditure	
1,51,341	As per Schedule 'I'	1,51,341
2,11,55,987		2,64,64,207

D. N. KAPUR
D. BANERJEE
N. G. MOOKERJEE
M. K. MOOKERJEE — *Directors.*
B. MOOKERJEE
K. KHESHVALA
J. H. MEHTA

K. N. MOOKERJEE *Managing Director.*
R. N. SENGUPTA *Secretary.*

NATIONAL RUBBER

PROFIT & LOSS ACCOUNT

1960			1961
Rs.		Rs.	Rs.
2,86,92,817	Brought forward ..		3,49,26,727
5,37,750	To **Interest :**		
	On Fixed Loan ..	2,21,214	
	„ Other Loans ..	5,40,344	
			7,61,558
7,70,739	„ Miscellaneous Expenses ..		8,49,277
2,62,198	„ Net Profit Carried Down ..		6,86,613
3,02,63,504			3,72,24,175
2,62,198	To Amount Transferred to Development Rebate Reserve ..		1,72,353
50,000	„ Amount Transferred to Dividend Equalisation Reserve		1,00,000
	„ Proposed dividend subject to deduction of Income Tax		
77,686	On Preference Shares ..	78,000	
—	„ Ordinary Shares ..	3,25,000	
			4,03,000
46,685	„ Balance Carried Forward ..		58,466
4,36,569			7,33,819

Note : (1) Miscellaneous expenses include fees Rs. 1,000/- paid to the auditors for attending the Board Meeting.

(2) Repairs include Rs. 11,109/- and Rs. 16,395/- being consumption of stores for Repairs to Plant & Machineries and Building & Structure respectively.

(3) Certain items included in consumption of Raw Materials in the previous year have been included in consumption of stores in this year.

CALCUTTA
6, Hastings Street,
The 28th February, 1962.

G. BASU & CO.
Chartered Accountants.

MANUFACTURERS LIMITED

FOR THE YEAR ENDED 31ST DECEMBER, 1961.

1960			1961
Rs.		Rs.	Rs.
3,02,63,504	Brought forward ..		3,72,24,175
3,02,63,504			3,72,24,175
14.523	By Balance Brought Forward ..		46,685
2,62,198	„ Net Profit this year ..		6,86,613
	„ Excess Provision of Dividend written back ..		521
1,59.848	„ Excess Provision of Income tax written back ..		—
4,36,569			7,33,819

D. N. KAPUR D. BANERJEE N. G. MOOKERJEE M. K. MOOKERJEE B. MOOKERJEE K. KHESHVALA J. H. MEHTA	}	*Directors.*
K. N. MOOKERJEE		*Managing Director.*
R. N. SENGUPTA		*Secretary.*

SCHEDULE "A"

The 31st December, 1960			The 31st December, 1961
Rs.	**Share Capital :**		Rs.
	Authorised :		
25,00,000	25,000 6% (Free of Income-tax) Cumulative Preference Shares of Rs. 100/- each		25,00,000
75,00,000	7,50,000 Ordinary Shares of Rs. 10/- each		75,00,000
1,00,00,000	Rs.		1,00,00,000
	Issued & Subscribed :		
10,00,000	10,000 6% (Free of Income-tax) Cumulative Preference Shares of Rs. 100/- each fully called up		10,00,000
50,00,000	5,00,000 Ordinary Shares of Rs. 10/- each called up		50,00,000
60,00,000			60,00,000
5,047	*Less* : Calls in Arrear		Nil
59,94,953	Rs.		60,00,000

Note : Of the above Shares, 80,000 Ordinary Shares of Rs. 10/- each are allotted as fully paid up, pursuant to a contract, without payments being received in cash.

SCHEDULE "B"

	Reserves and Surplus :		
Nil	**Capital Reserve :**		
	Surplus on Re-issue of Forfeited Shares		4,774
	Share Premium Account ..		939
	General Reserve		
4,00,000	As per last account		4,00,000
	Development Rebate Reserve		
7,28,074	As per last account ..	7,28,074	
	Add: Amount transferred from Profit and Loss Account ..	1,72,353	
			9,00,427
	Dividend Equalisation Reserve		
1,00,000	As per last account ..	1,00,000	
	Add: Amount transferred from Profit and Loss Account ..	1,00,000	
			2,00,000
46,685	**Profit & Loss Account** . ..		58,466
12,74,759			15,64,606

SCHEDULE "C"

The 31st December, 1960		The 31st December, 1961
Rs.	**Secured Loans**	Rs.
39,63,963	**From a Bank :** .. .. .. Secured by hypothecation of Company's stock of rubber, canvas, galvanised wire, chemicals and rubber goods whether raw or in process of manufacture and all products, goods which now or hereafter from time to time during this security shall be brought into, stored or be in or about Company's premises or godowns in the State of West Bengal and also all goods in course of transit and Book debts as per contra.	53,54,372
22,39,296	**From Banks :** .. .. .. Secured against hypothecation of Stock at Branches and or Supply Bills per contra.	37,32,691
34,00,000	**From Industrial Finance Corporation of India** Secured by Mortgage of the Company's Fixed Assets both present and future. The Loan is also guaranteed by five of the Directors of the Company.	33,00,000
8,726	**Interest Accrued on Secured Loan**	11,359
96,11,985	Rs.	1,23,98,422

Note : Four of the Wholetime Directors of the Company have guaranteed the above overdrafts from Banks.

SCHEDULE "D"

Unsecured Loans

Nil	**From a Bank** .. .. .. (Guaranteed by Four of the Wholetime Directors of the Company)	19,45,987
3,00,000	**From Others**	2,00,000
1,461	**Interest Accrued on Unsecured Loan** ..	16,000
3,01,461		21,61,987

SCHEDULE "F"

Fixed

Description of Assets	Cost to 31st December, 1960	Addition during the year to 31st December, 1961
	Rs.	Rs.
Goodwill	46,277	—
Land	45,000	—
Building & Structure	11,74,616	2,50,219
Monthly Tenancy Right	500	—
Plant & Machinery	74,23,434	4,43,598
Electric Installation	3,29,967	1,77,046
Moulds	8,62,308	11.270
Furniture & Fittings	3,00,522	62.443
Typewriters	40,738	15,042
Tools & Implements	1.51,846	47.949
Motor Cars & Lorries	1.41,070	12,759
Books & Periodicals	5,556	—
Tubewells	71,724	1.007
Total Rs. ..	1,05.93,558	10,21,333 Note
Figures for the 31st December, 1960 ..	83,55,363	22,33,295

Note : Allocation of Capital expenses incurred departmentally, as certified by the Technical Director, has been incorporated in these accounts.

SCHEDULE "F"

Assets

Deductions during the year to 31st December, 1961	Total Cost to 31st December, 1961	Total Depreciation written off to 31st December, 1961	Net Value of Assets as at 31st December, 1961	Net Value of Assets as at 31st December, 1960
Rs.	Rs.	Rs.	Rs.	Rs.
—	46,277	—	46,277	46,277
—	45,000	—	45,000	45,000
—	14,24,835	2,87,036	11,37,799	9,53,366
—	500	—	500	500
—	78,67,032	32,73,574	45,93,458	46,46,550
—	5,07,013	63,294	4,43,719	2,90,145
—	8,73,578	7,39,793	1,33,785	1,71,526
250	3,62,715	84,739	2,77,976	2,40,757
565	55,215	29,868	25,347	14,586
—	1,99,795	52,753	1,47,042	1,13,586
4,931	1,48,898	1,06,749	42,149	44,877
—	5,556	1,044	4,512	4,512
—	72,731	12 893	59,838	63,620
5,746	1,16,09,145	46,51,743	69,57,402	66,35,302
100	1,05,93,558	39,58,256	66,35,302	

SCHEDULE "E"

Current Liabilities and Provisions

The 31st December, 1960 Rs.		The 31st December, 1961 Rs.
	(A) Current Liabilities	
27,72,310	Sundry Creditors for Goods supplied	28,07,885
7,00,090	Sundry Creditors for Expenses ..	6,44,635
3,81,581	Sundry Creditors for other Finance ..	4,63 290
18.063	Liability for Income-tax	—
6,533	Unclaimed Dividends	6,314
16,566	Due to Trustees of Provident Fund ..	14,068
38,95,143		39,36,192
	(B) Provisions	
77.686	Proposed Dividend	4,03,000
39,72.829	Rs.	43,39,192

[For Schedule 'F' See Pages 346 and 347]

SCHEDULE "G"

Investments, at Cost

Investment in Government Securities (Other Investments)

		Face Value	Cost
7.000	4% West Bengal Government Loan	Rs. 7,000	7,000
1,450	National Savings Certificates	Rs. 1,450	1,450
8 450		Rs.	8,450

Note :

Market Value	Book Value		Book Value	Market Value
6,895	Rs. 7,000	Quoted Investments .	Rs. 7,000	6,930
—	Rs. 1,450	Unquoted Investments ..	Rs. 1,450	—
	Rs. 8,450		Rs. 8,450	

SCHEDULE "H"

The 31st December, 1960				The 31st December, 1961
Rs.	**Current Assets, Loans & Advances**		Rs.	Rs.
	(A) **Current Assets**			
755	(1) Interest accrued on Investment ..		1,035	
	(2) **Stock-in-trade**			
	As per inventories taken, valued and certified by the Managing Director.			
33.69,985	(a) Raw Materials, at cost	39,99,572		
52,98,153	(b) Finished Goods, at or below net selling price ..	97,02,231		
5,61,075	(c) Stores & Spare Parts, at cost ..	4.77,297		
5,45,737	(d) Work-in-Progress, at cost	3,15,209		
3,15,763	(e) Stock-in-Transit, at cost	1,19,152		
			1,46,13.461	
29,69,455	(3) **Sundry Debtors**			
	(a) Debts outstanding for a period exceeding six months	3,65,116		
	(b) Other Debts ..	30,73,410		
			34,38,526	
	(4) **Cash and Bank Balances**			
3,22,632	(i) At Banks on Current Account ..	1,41.354		
6,533	(ii) At Banks on Dividend Account ..	6,314		
1,57,065	(iii) At Bank on Fixed Deposit ..	1,15,365		
50.898	(iv) Cash in Hand ..	1,18 338		
20.000	(v) Cash in Transit ..	—		
			3,81,371	
				1,84,34,393
	(B) **Loans and Advances**			
2.87,528	(i) Advances recoverable in cash or in kind or for value to be received ..	..	4.30.083	
3,56,726	(ii) Advances to Staff	..	3,51,915	
	Security Deposits			
26,636	(a) With Government Departments ..	29,266		
8,885	(b) With Public Utility Concerns ..	9,275		
29.894	(c) Others ..	73.546		
			1,12.087	
33,174	Balance with Customs, Port Trust etc. ..	..	8.661	
—	Advance payment of Income-tax ..	..	9,875	
				9,12,621
1,43,60,894			Rs.	1,93,47,014

SCHEDULE 'H'—*Contd.*

The 31st December, 1960 Sundry Debtors Rs.	Loans & Advances	Particulars	The 31st December, 1961 Sundry Debtors	Loans & Advances Rs.
Nil	Nil	(i) Debts considered good and in respect of which the Company is fully secured	Nil	Nil
28,41,091	2,26,740	(ii) Debts considered good and in respect of which the Company held no security other than the Debtors' Personal Security ..	32,78,849	5,47,399
1,15.615	3,17,397	(iii) Debts considered doubtful or bad ..	1,59,677	3,65,222
29,56,706	5,44,137		34,38,526	9,12,621

DIRECTORS' CERTIFICATE

In the opinion of the Board, the Current Assets and Loans and Advances if realised in the ordinary course of business will amount at least to the value at which they are stated in the Balance Sheet.

SCHEDULE "I"

Miscellaneous Expenditure

	(i) **Expenses on the Issue of new Shares**	
51,244	As per last Balance Sheet	51,244
	(ii) **Brokerage on the issue of new Shares**	
53,304	As per last Balance Sheet	53,304
	(iii) **Expenses on the procurement of Loan from Industrial Finance Corporation of India**	
46,793	As per last Balance Sheet	46,793
1,51,341	— Rs.	1,51,341

Appendix E

FORM OF A BANK BALANCE SHEET AS GIVEN UNDER THE THIRD SCHEDULE, FORM A (Sec. 29) OF THE BANKING COMPANIES ACT, 1949

CAPITAL AND LIABILITIES	Rs. a. p.	Rs. a. p.
1. CAPITAL		
Authorised Capital :		
.. ....Shares of Rs.......each......		
Issued Capital :		
........Shares of Rs.......each......		
Subscribed Capital :		
........Shares of Rs.......each......		
Amount Called up at Rs......per share.....		
Less : Calls unpaid		
Add : Forfeited Shares		
2. RESERVE FUND AND OTHER RESERVES		
3. DEPOSITS AND OTHER ACCOUNTS :		
Fixed Deposits		
Savings Bank Deposits		
Current Accounts and Contingency A/cs.		
4. BORROWINGS FROM OTHER BANKS AGENTS ETC :		
(i) in India		
(ii) outside India		
Particulars :		
(i) Secured (stating the nature of security)		
(ii) Unsecured		
5. BILLS PAYABLE		
6. BILLS FOR COLLECTION BEING BILLS RECEIVABLE (*per contra*) :		
(i) payable in India		
(ii) payable outside India		
7. OTHER LIABILITIES (to be specified) : Pension or Insurance Fund, Unclaimed Dividends, Advance Payments, Rebate on Bills discounted, etc.		
8. ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS (*per contra*) :		
Carried Forward Rs.		

PROPERTY AND ASSETS	Rs. a. p.	Rs. a. p.
1. CASH : In hand and with Reserve Bank (including foreign currency notes)		
2. BALANCES WITH OTHER BANKS (Showing whether on deposit or current account)		
(i) in India		
(ii) outside India		
3. MONEY AT CALL AND SHORT NOTICE		
4. INVESTMENTS (Stating mode of valuation, e.g., cost or market value) :		
(i) Securities of the Central and State Governments and Trustee Securities including Treasury Bills of the Central and State Governments		
(ii) Shares (classifying into preference, ordinary, deferred and other classes of shares and showing separately shares fully paid up and partly paid up)		
(iii) Debentures or Bonds		
(iv) Other investments (to be classified under proper heads)		
(v) Gold		
5. ADVANCES :		
(i) Loans, Cash Credits and Overdrafts (other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors) :		
(a) in India		
(b) outside India		
(ii) Bills discounted and purchased (other than Treasury Bills of the Central and State Governments) :		
(a) payable in India		
(b) payable outside India		
Particulars :		
(i) Debts considered good in respect of which the Bank is fully secured ..		
(ii) Debts considered good for which the Bank holds no other security than the debtors' personal security		
Carried Forward Rs.		

CAPITAL AND LIABILITIES	Rs. a. p.	Rs. a. p.
Brought forward Rs.		
9. PROFIT AND LOSS ACCOUNT:		
As per last Balance Sheet		
Less: Appropriations		
Add: Profit for the year brought forward from P & L Account ..		
10. CONTINGENT LIABILITIES ..		
Total Rs.		

PROPERTY AND ASSETS	Rs. a. p.	Rs. a. p.
Brought forward Rs.		
(iii) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the debtors		
(*iv*) Debts considered doubtful or bad, not provided for		
(v) Debts due by directors or officers of the Bank or any of them either severally or jointly with any other persons ..		
(vi) Debts due to companies or firms in which the directors of the Bank are interested as directors, partners or managing agents or, in the case of private companies, as members ..		
(vii) Maximum total amount of loans, including temporary advances made at any time during the year to directors or managers or officers of the company ..		
(viii) Maximum total amount of loans, including temporary advances granted during the year to the companies or firms in which the directors of the bank are interested as directors, partners or managing agents or, in the case of private companies, as members		
(ix) Due from banks		
6. BILLS FOR COLLECTION BEING BILLS RECEIVABLE *as per contra* :		
(i) payable in India		
(ii) payable outside India		
7. CONSTITUENTS' LIABILITIES FOR ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS *per contra* ..		
8. PREMISES *less* Depreciation		
9. FURNITURE AND FIXTURES *less* Depreciation		
10. OTHER ASSETS, including silver (to be specified)		
11. NON-BANKING ASSETS, acquired in satisfaction of claims (stating mode of valuation)		
12. PROFIT AND LOSS		
Total Rs.		

Appendix F

FORM OF A BANK PROFIT AND LOSS ACCOUNT AS GIVEN UNDER THE THIRD SCHEDULE, FORM B OF THE BANKING COMPANIES ACT, 1949

Profit and Loss Account for the year ended......December

EXPENDITURE	Rs.	a.	p.	INCOME (*less Provision made during the year for Bad and Doubtful Debts*)	Rs.	a.	p.
1. Interest paid on deposits, borrowings, etc.				1. Interest and Discount ..			
2. Salaries and Allowances (showing separately salaries and allowances to managing director or manager) ..				2. Commission, Exchange and Brokerage ..			
3. Contributions to Provident Fund ..				3. Rents ..			
4. Directors' fees and allowances .. Local Committee Members' fees and allowances				4. Net Profit on sale			
5. Rent, Taxes, Insurance, Lighting etc.				5. Net Profit on sale of investments, gold and silver, land, premises and other assets ..			
6. Law Charges ..				6. Net Profit on revaluation of investments, gold and silver, land, premises and other assets ..			
7. Postage, Telegrams and stamps ..				7. Income from non-banking assets, and profit from sale of or dealing with such assets ..			
8. Auditor's Fees ..				8. Other receipts ..			
9. Depreciation on Bank's Property				9. Loss (if any) ..			
10. Repairs to Bank's Property							
11. Stationery, Printing, Advertisement etc.							
12. Loss from sale of or dealing with non-banking assets							
13. Other Expenditure							
14. Balance (Net Profit) subject to taxation							
Total Rs.				Total Rs.			

Appendix G

FORM OF REVENUE ACCOUNT APPLICABLE TO FIRE INSURANCE BUSINESS, MARINE INSURANCE BUSINESS AND OTHER MISCELLANEOUS INSURANCE BUSINESS AS GIVEN UNDER THE THIRD SCHEDULE, FORM F OF THE INSURANCE ACT, 1938.

REVENUE ACCOUNT OF........FOR THE YEAR ENDED...........19

IN RESPECT OF..........BUSINESS

	Rs.		Rs.
Claims under Policies, less Re-insurances: Paid during the year Rs. Total estimated liability in respect of outstanding claims at the end of the year whether due or intimated. Rs. Total Rs. Less outstanding at the end of the previous year Rs.		Balance of Account at the beginning of the year Reserve for Unexpected Risks .. Rs. Additional Reserve (if any) .. Rs.	
Commission ..		Premiums less Re-insurances	
Commission on Direct Business		Interest, Dividends and Rents Rs. Less Income tax Rs.	
Commission on Re-Insurances accepted ..		Commission on Re-insurances ceded	
Expenses of management		Other income (to be specified)	
Bad debts		Loss transferred to Profit & Loss A/c-	
United Kingdom, Indian Dominion and Foreign Taxes		Transfer from Appropriation Account	
Other Expenditure (to be specified)			
Profit transferred to Profit and Loss Account ..			
Balance of Account at the end of the year as shown in the Balance Sheet Rs. Additional Reserve (if any) Rs.			
Rs.		Rs.	

Appendix H

FORM OF PROFIT AND LOSS ACCOUNT FOR INSURANCE COMPANIES AS GIVEN UNDER THE INSURANCE ACT, 1938.

A. THE SECOND SCHEDULE FORM B.

Profit & Loss Account of ....for the year ended........

Indian (Central) Taxes on the insurer's Profits (not applicable to any particular Fund or Account)	Interests Dividends and Rents (not applicable to any particular Fund or Account) .. *Less*, Income tax thereon
Expenses or Management (not applicable to any particular Fund or Account.	Profit on realisation of Investment (not credited to Reserves or any particular Fund or Account) .
Loss on Realisation of Investment (not charged to Reserves or any particular Fund or Account) ..	Appreciation of Investments (not credited to Reserves or any Particular Fund or Account) .
Depreciation of Investment (not charged to Reserves or any particular Fund or Account) .. .	Profit transferred from Revenue Accounts (details to be given) ..
Loss transferred from Reserve Accounts (details to be given)	Transfer fees .
Other Expenditure (to be specified)	Other Income (to be specified)
Balance for the year carried to Appropriation Account .	Balance being loss for the year carried to Appropriation Account ..

B THE SECOND SCHEDULE FORM C

Profit & Loss Appropriation Account of. for the year ended..19...

Balance being loss brought forward from last year ..	Balance brought forward from last year .. .. *Less* Dividends since paid in respect of last year (to be specified and if "free of tax" to be so stated) .
Balance being loss for the year brought from Profit and Loss Account (as in Form B)	Balance for the year brought from Profit and Loss Account (as in Form B) ..
Dividends paid during the year on account of the current year (to be specified and if "free of tax" to be so stated) . ..	Balance being Loss at end of the year as shown in the Balance Sheet ..
Transfers to any particular Funds or Accounts (details to be given)	
Balance at end of the year as shown in the Balance Sheet	

Appendix I

FORM OF INSURANCE COMPANY BALANCE SHEET AS GIVEN THE FIRST SCHEDULE, FORM A OF THE INSURANCE ACT, 1938

Balance Sheet of..........

	Life and Annuity Business	Other Classes of Business	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
SHAREHOLDERS' CAPITAL (each class to be stated separately)			
Authorised :			
......shares of Rs......each Rs.			
Subscribed :			
......shares of Rs......each Rs.			
Called up :			
......shares of Rs......each Rs.			
Less Unpaid Calls Rs.			
RESERVE OF CONTINGENCY ACCOUNTS :			
Investment Reserve Account ..			
Profit and Loss Appropriation Account Balance ..			
BALANCES OF FUNDS AND ACCOUNTS :			
Life Insurance Fund—			
(i) Business in India			
(ii) Business outside India ..			
Fire Insurance Business Account ..			
Marine Insurance Business Account			
Miscellaneous Insurance Business Account ..			
Other accounts, if any (to be specified) ..			
Pension or Superannuation Account			
DEBENTURE STOCK per cent ..			
LOANS AND ADVANCES			
BILLS PAYABLE ..			
ESTIMATED LIABILITY IN RESPECT OF OUTSTANDING CLAIMS, WHETHER DUE OR INTIMATED			
ANNUITIES DUE AND UNPAID			
Carried over Rs.			

..........*at at*..........*19*

	Life and Annuity Business	Other Classes of Business	Total
	Rs. a. p.	Rs. a. p.	Rs. a. p.
LOANS :			
On Mortgages of property within the States			
On Mortgages of property outside the State			
On security of municipal and other public rates			
On stocks and shares			
On Insurer's Policies within their surrender value			
On personal security			
To Subsidiary Companies (other than Reversionary)			
Reversions and Life Interests purchased			
Loans on Reversions and Life Interests			
Debentures and Debenture Stock of Subsidiary Reversionary Companies			
Ordinary Stocks and Shares of Subsidiary Reversionary Companies			
Loans to Subsidiary Reversionary Companies			
INVESTMENTS :			
Deposit with the Reserve Bank of India (securities to be specified)			
Indian Government Securities ..			
State Government Securities ..			
British, British Colonial and British Dominion Government Securities			
Foreign Government Securities ..			
Indian Municipal Securities ..			
British and Colonial Securities ..			
Foreign Securities			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the Indian Government or a State Government ..			
Carried over Rs.			

THE FIRST SCHEDULE

	Life and Annuity Business	Other Classes of Business	Total
Brought forward Rs.	Rs. a. p.	Rs. a. p	Rs. a. p.
OUTSTANDING DIVIDENDS ..			
AMOUNTS DUE TO OTHER PERSONS OR BODIES CARRYING ON INSURANCE BUSINESS			
SUNDRY CREDITORS (INCLUDING OUTSTANDING AND ACCRUING EXPENSES AND TAXES)			
OTHER SUMS OWING BY THE INSURER (PARTICULARS TO BE GIVEN)			
CONTINGENT LIABILITIES (TO BE SPECIFIED)			
Carried over Rs.			

FORM A (*Contd.*)

	Life and Annuity Business	Other Classes of Business	Total
Brought forward Rs.	Rs. a. p.	Rs. a. p.	Rs. a. p.
Bonds, Debentures, Stock and other Securities whereon Interest is guaranteed by the British or any Colonial Government			
Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by any Foreign Government			
Debentures of any railway in India			
Debentures of any railway out of India			
Preference or guaranteed shares of any railway in India			
Preference or guaranteed shares of any railway out of India ..			
Railway ordinary stock (i) in India, (ii) out of India			
Other Debentures and Debenture Stock of Companies incorporated (i) in India, (ii) out of India ..			
Other guaranteed and Preference Stocks and Shares of companies incorporated (i) in India, (ii) out of India			
Other ordinary Stocks and Shares of Companies incorporated (i) in India, (ii) out of India ..			
Holdings in Subsidiary Companies			
House Property (i) in India, (ii) out of India			
Freehold and Leasehold ground rents and rent charges			
AGENTS' BALANCES			
OUTSTANDING PREMIUMS ..			
INTEREST, DIVIDENDS AND RENTS OUTSTANDINNG ..			
INTEREST, DIVIDENDS AND RENTS ACCRUING BUT NOT DUE			
Carried over Rs.			

THE FIRST SCHEDULE

	Life and Annuity Business	Other Classes of Business	Total
Brought forward Rs.	Rs. a. p.	Rs. a. p.	Rs. a. p.
Rs.			

FORM A (*Contd.*)

	Life and Annuity Business	Other Classes of Business	Total
Brought forward Rs.	Rs. a. p.	Rs. a. p.	Rs. a. p.
AMOUNTS DUE FROM OTHER PERSONS OR BODIES CARRYING ON INSURANCE BUSINESS			
SUNDRY DEBTORS			
BILLS RECEIVABLE			
CASH :			
At Bankers on Deposit Account ..			
At Bankers on Current Account .. and in hand			
At Call and Short Notice ..			
Other Accounts (to be specified) ..			
Rs.			

Appendix J

SPECIMENS OF AUDIT REPORT

Auditors' Report to the Members of......Company Limited

We report that we have audited the above Balance Sheet and the annexed Trading and Profit and Loss Account which are in agreement with the books of account and returns and, in our opinion and to the best of our information and according to the explanations given to us, such Balance Sheet and Trading and Profit and Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 31st March, 1959 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion proper books of account have been kept as required by law, so far as appears from our examination of those books, and proper returns audited by qualified persons have been received from Branches not visited by us.

Calcutta, 1st October, 1959. *Chartered Accountants.*

Auditors' Report to the Members of......Company Limited

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by law so far as appears from our examination of those books, and proper returns adequate for the purposes of our audit have been received from the Factory not visited by us.

We have examined the Balance Sheet of........Company, Limited, as at 31st December, 1958, and the annexed Profit and Loss Account for the year ended on that date which are in

agreement with the books of account and returns. In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 31st December, 1958, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

Calcutta, 25th August, 1959 *Chartered Accountants.*

Auditors' Report to the Shareholders.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by Law so far as appears from our examination of those books, and proper returns adequate for the purposes of our audit have been received from the Forest Head Quarter and Depots not visited by us.

We have examined the Balance Sheet of........Company Private Limited, as at 30th September, 1958, and the annexed Profit and Loss Account for the year ended on that date which are in agreement with the books of account and returns. In our opinion and to the best of our information and according to the explanations given to us the said accounts give the information required by the Companies Act, 1956, in the manner so required, and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 30th September, 1958, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

Calcutta, 17th April, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Tea Company Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit & Loss Account which are in agreement with the books of account, and, in our opinion and to the best

of our information and according to the explanations given to us, such Balance Sheet and Profit & Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 31st December, 1958 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit and, in our opinion, proper books of account have been kept as required by law so far as appears from our examination of those books.

Calcutta, ...& Co., } *Auditors.*
2nd July, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Pharmaceuticals Private Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit and Loss Account which are in agreement with the books of account and in our opinion and to the best of our information and according to the explanations given to us, such Balance Sheet and Profit and Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 30th September, 1958 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit and, in our opinion, proper books of account have been kept as required by law so far as appears from our examination of those books.

Calcutta, 25th March, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Small Scale Industries Ltd.

We report that we have audited the above Balance Sheet and the annexed Trading and Profit and Loss Account which are in agreement with the books of account and in our opinion

and to the best of our information and according to the explanations given to us, such Balance Sheet and Trading and Profit and Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 31st March, 1959 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit and, in our opinion, proper books of account have been kept as required by law so far as appears from our examination of the books.

Calcutta, 30th September, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Merketing (India) Private Limited

We have examined the above Balance Sheet and the annexed Profit and Loss Account which are in agreement with the Company's books of account.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit. In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of these books.

In our opinion and to the best of our information and according to the explanations given to us the said Balance Sheet and Profit and Loss Account give the information required by the Companies Act 1956, in the manner so required and present a true and fair view of the state of the Company's affairs as at 31st December, 1958 and of the loss for the year ended on that date.

Calcutta, ...& Co.,
12th May, 1959 *Chartered Accountants,* } *Auditors.*

Auditors' Report to the Members of...... Tea Association Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit & Loss Account which are in agreement with the books of account, and, in our opinion and to the best of our information and according to the explanations given to us, such Balance Sheet and Profit & Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 31st December 1958 and its loss for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit and, in our opinion, proper books of account have been kept as required by law so far as appears from our examination of those books.

Calcutta,	................& Co.,	*Auditors.*
2nd July, 1959	*Chartered Accountants.*	

Auditors' Report to the Members of the......Tea Company Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit and Loss Account which are in agreement with the books of account, and, in our opinion and to the best of our information and according to the explanations given to us, such Balance Sheet and Profit and Loss Account give in the prescribed manner the information required by the Companies Act 1956 and also give respectively a true and fair view of the state of the Company's affairs as at 31st December 1958 and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit and, in our opinion, proper books of account have been kept as required by law so far as appears from our examination of those books.

Calcutta,	................& Co.,	*Auditors.*
21st August, 1959	*Chartered Accountants,*	

Auditors' Report to the Members

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by law so far as appears from our examination of those books, and proper returns adequate for the purposes of our audit have been received from the branch office not visited by us.

We have examined the Balance Sheet of.........., Limited as at 31st March, 1959 and the annexed Profit and Loss Account for the year ended on that date which are in agreement with the books of account and returns.

Subject to the note appearing on the Profit and Loss Account regarding the Managing Director's remuneration, in our opinion and to the best of our information and according to the explanations given to us, the said accounts read in conjunction with the notes appearing on Pages 12 to 16 give the information required by the Companies Act, 1956, in the manner so required, and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 31st March, 1959 and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

Calcutta, 7th October, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......and Company Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit and Loss Account and in our opinion and to the best of our information and according to the explanations given to us the above Balance Sheet and annexed Profit and Loss Account give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 31st March, 1959, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our

audit. In our opinion proper books of account have been kept as required by law so far as appears from our examination of those books. In our opinion the above mentioned accounts are in agreement with the books of account.

Calcutta, 6th October, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......and Company Ltd.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the Company as required by law so far as appears from our examination of those books.

We have examined the Balance Sheet of............and Company, Limited as at 31st March, 1959 and the annexed Profit and Loss Account for the year ended on that date which are in agreement with the books of account. In our opinion and to the best of our information and according to the explanations given to us, the said accounts read in conjunction with the note appearing on page No. 29 give the information required by the Companies Act, 1956, in the manner so required and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 31st March, 1959, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

Calcutta, 7th October, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Finance Ltd.

We report that we have audited the above Balance Sheet and the annexd Profit and Loss Account and in our opinion and to the best of our information and according to the explanations given to us the above Balance Sheet and the annexed Profit and Loss Account give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the

Company's affairs as at 31st March, 1959, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion proper books of account have been kept as required by law so far as appears from our examination of those books. In our opinion the above mentioned accounts are in agreement with the books of account.

Calcutta, 6th October, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Limited

We report that we have audited the above Balance Sheet and the annexed Profit and Loss Account and, in our opinion and to the best of our information and according to the explanations given to us, such Balance Sheet and Profit and Loss Account, which are in agreement with the books, give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 31st March, 1959, and its profit for the year ended on that date.

Calcutta, 30th September, 1959 *Chartered Accountants.*

Auditors' Certificate and Report to the Members of...... & Company Ltd.

We certify that we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit, and, in our opinion, proper books of account have been kept by the Company so far as appears from our examination of those books. We have examined the above Balance Sheet and annexed Profit and Loss Account which are in agreement with the books of account. In our opinion and to the best of our information and according to the explanations given to us the said Acounts give the information required by the Companies Act 1948 in the manner so required and the Balance Sheet gives a true and fair view

of the state of the Company's affairs as at 31st March 1959, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date.

LONDON,

28th September, 1959 *Chartered Accountants.*

Report of Auditors to the Members of......Company Ltd.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit. In our opinion proper books of account have been kept by the Company so far as appears from our examination of those books, and proper returns adequate for the purpose of our audit have been received from the Company's Registrars in London and the Garden Manager.

We have examined the above Balance Sheet and annexed Profit and Loss Account which are in agreement with the books of Account and Returns.

In our opinion and to the best of our information and according to the explanations given to us the said Accounts with the notes thereon give the information required by the Companies Act, 1948, in the manner so required and the Balance Sheet gives a true and fair view of the state of the Company's affairs as at 31st December, 1958 and the Profit and Loss Account gives a true and fair view of the loss for the year ended on that date.

Calcutta, 3rd October, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Private Ltd.

We have audited the above Balance Sheet of.......... Private Ltd., as at 31st March, 1959, and the annexed Profit and Loss Account of the Company for the year ended on that date, and report that :

(1) We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(2) In our opinion proper books of account as required by law have been kept by the Company, so far as appears from our examination of the books.

(3) The Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account.

(4) In our opinion and to the best of our information and according to the explanations given to us, the Accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view :

(a) in the case of the Balance Sheet, of the state of the affairs of the Company as at 31st March, 1959, and

(b) in the case of the Profit and Loss Account, of the profit for the year ended on that date.

Calcutta, 25th September, 1959 *Chartered Accountants.*

Auditors' Report to the Members of......Tea Company Ltd.

We report that we have audited the above Balance Sheet and the annexed Profit and Loss Account which are in agreement with the books and in our opinion and to the best of our information and according to the explanations given to us the above Balance Sheet and the annexed Profit and Loss Account together with the relevant notes give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 31st December 1960, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary

for our audit. In our opinion proper books of account have been kept as required by law so far as appears from our examination of those books.

Calcutta, 29th May, 1961 *Chartered Accountants.*

AUDITORS' REPORT

To the Share Holders of........Limited

We report that we have audited the Balance Sheet of Messrs...........Ltd., as at 30th September, 1961, and the annexed Profit and Loss Account for the year ended on that date. In our opinion and to the best of our information and according to the explanations given to us, the said Balance Sheet and the annexed Profit and Loss Account together with the notes thereon give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 30th September, 1961, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion proper books of account have been kept as required by law, so far as appears from our examination of those books, and proper returns adequate for the purpose of our audit have been received from Branches not visited by us. These Branches are exempt from the requirements of Section 228 by virtue of Rule 3 of the Companies (Branch Audit Exemption) Rules, 1961. The above mentioned accounts are in agreement with the books of account and returns.

CALCUTTA,

19th February, 1962 *Chartered Accountants*

Auditors' Report to the Shareholders of......Textile Mills Limited

To

The Shareholders,

........TEXTILE MILLS LTD.,

Calcutta.

Dear Sirs,

We have audited the attached Balance Sheet of.......... Textile Mills Ltd., as at 30th June, 1961 and the annexed Profit & Loss Account for the year ended on that date together with the schedules referred to therein.

The following discrepancies are observed :—

(1) **Current Assets:**

Debts outstanding for a period exceeding 6 months.

A sum of Rs. 1,04,573/- is due from Sri.......... for sale of bricks by the Company. As no amount has been paid by him the case has been handed over to Company's Solicitors for necessary action.

(2) **Depreciation:**

The Provision of Depreciation for the year under audit is not adequate.

Subject to above, in our opinion and to the best of our information and according to the explanations given to us the said accounts give the information required by the Companies Act, 1956 in the manner so required and the Balance Sheet gives a true and fair view of the state of Company's affairs as at 30th June, 1961 and the Profit & Loss Account gives a true and fair view of the Profit for the year ended on that.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion proper books of account have been kept by the Company as required by law so far as appears from our examination of those books and the

Balance Sheet and Profit & Loss Account of the Company are in agreement with the books of account.

CALCUTTA,
December 23, 1961.

Yours faithfully,
....
Chartered Accountants,
Auditors.

Auditors' Report to the Shareholders of......Bank, Limited

We have audited the annexed Balance Sheet of............ Limited as on..........and also the annexed Profit and Loss Account of the Bank for the year ended on that date in which are incorporated the returns of..........Branches audited by us,..........Branches audited by other auditors and the unaudited returns from........other Branches not visited by us.

In accordance with the provisions of Section 29 of the Banking Companies Act, 1949, read with the provisions of sub-sections (1) and (2) of section 211 and sub-section (5) of Section 211 and Section 227 (5) of Companies Act, 1956 the Balance Sheet and Profit & Loss Account are not required to be and are not drawn up in accordance with the Sixth Schedule of the Companies Act, 1956. The Accounts are therefore drawn up in conformity with Forms A & B of the Third Schedule to the Banking Companies Act, 1949.

We report that :

(a) we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit and have found them to be satisfactory ;

(b) *the transactions of the bank, which have come to our notice, have been within the powers of the Bank ;*

(c) in our opinion, proper books of account as required by law have been kept by the Bank so far as appears from our examination of those books and proper returns adequate for the purpose of our audit have been received from the branches of the Bank ;

(d) the Bank's Balance Sheet and Profit & Loss Account dealt with by this report are in agreement with the books of account and the returns ;

(e) in our opinion, and to the best of our information and, according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required for banking companies, and on such basis the said Balance Sheet gives a true and fair view of the state of the affairs of the Bank at at.................. and the Profit & Loss Account gives a true and fair view of the profit for the year ended upon that date.

Calcutta,..........1960. *Chartered Accountants.*

Auditors' Report to the Members of......Insurance Company Limited

1. We have audited the annexed Balance Sheet of the.... ....Insurance Company, Limited, as at......and........ the *Fire, Marine and Miscellaneous Insurance Revenue Accounts,* the Profit and Loss Account and the Profit and Loss Appropriation Account of the Company for the year ended upon that date, in which are incorporated the authenticated Returns from Agencies, Treaty Companies and the audited Returns from Branches.

2. We report that :

(a) We have obtained all the information and explanation which, to the best of our knowledge and belief, were necessary for the purpose of our audit ;

(b) in our opinion, proper books of accounts, as required by law, have been kept by the Company, so far as appears from our examination of those books, and proper Returns adequate for the purpose of our audit have been received from the Branches not visited by us ;

(c) the Company's Balance Sheet, *Fire, Marine and Miscellaneous Revenue Accounts,* Profit and Loss

Account and Profit and Loss Appropriation Account, dealt with by this Report, are in agreement with the books of accounts and returns ;

(d) in our opinion and to the best of our information, and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required as applicable to Insurance Companies, and on such basis, the said Balance Sheet gives a true and fair view of the state of the Company's affairs as at........, and the Profit and Loss Account gives a true and fair view of the profit for the year ended on that date ;

(e) *we have verified the Cash and Bank Balance and the Investments of the Company by the production of Certificates and Documents and the Securities relating to the Loans ;*

(f) *all charges incurred in respect of the Company's business have been fully debited in the respective Revenue Accounts as per separate Certificate attached thereto.*

Calcutta,..........1962. *Chartered Accountants.*

Report to be Submitted by Auditors' Appointed by Life Insurance Coporation of India

We have, under Sec. 25 of the Life Insurance Corporation Act, 1956, audited the attached *General* Balance Sheet and the attached Balance Sheets of the *Life*, *General* and *Capital Redemption Business* Departments of the Corporation as at.... Also we have audited the *Life, Fire, Marine* and *Miscellaneous Revenue Accounts*, the Capital Redemption Insurance Fund Account, the Profit and Loss Account and the Profit and Loss Appropriation Account of the Corporation for the year ended upon that date, and report that :

(a) we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our Audit ;

(b) in our opinion, proper books of accounts, as required by law, have been kept so far as appears from our examination of those books, and proper returns adequate for the purpose of our Audit have been received from the branches not visited by us ;

(c) the Balance Sheet and Revenue Account dealt with by this Report are in agreement with the books of accounts and returns ;

(d) in our opinion, and to the best of our information, and according to the explanations given to us, the said Accounts convey the information required by the Companies Act, 1956, in the manner so required as applicable to *Life Insurance Business*, and on such basis the said Balance Sheet gives a true and fair view of the state of the affairs as at............ ;

(e) *we have verified the Cash and Bank Balances and the Investments, by inspection or by production of certificates or vouchers, and have also verified the securities relating to the corporation's loans on Policies ;*

(f) *no part of the Life Assurance Fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and the investment of the Life Assurance Fund ;*

(g) *all charges incurred in respect of Life Insurance Business have been fully debited in the respective Revenue Account as per certificates attached thereto.*

Dated *Chartered Accountants.*

Auditors' Report to the Members of......Coal Company Ltd.

We report that we have audited the Balance Sheet of............Coal Company, Limited, as at 31st March, 1958, signed by us under reference to this report, and the relative Profit and Loss Account and in our opinion and to the best of our information and according to

the explanations given to us the Balance Sheet and Profit and Loss Account give in the prescribed manner the information required by the Companies Act, 1956, and also give respectively a true and fair view of the state of the Company's affairs as at 31st March, 1958, and its profit for the year ended on that date.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for our audit. In our opinion, proper books of account have been kept as required by law as far as appears from our examination of the books and the above mentioned accounts are in agreement therewith.

Calcutta, 2nd September, 1958. *Chartered Accountants.*

Appendix K

PROVISIONS OF THE COMPANIES (Branch Audit Exemption) RULES, 1961 PROMULGATED BY THE CENTRAL GOVERNMENT IN EXERCISE OF POWERS CONFERRED BY SEC. 228(4) [Vide Page 312] OF THE COMPANIES ACT

(i) A Company carrying on any manufacturing, processing or trading activity whose average *quantum of activity** does not exceed Rs. 2 lakhs or 2% of (a) the average of the total turnover of the Company (including its Branches and other offices) and (b) earnings from services rendered and from any other source, whichever is higher, shall be exempt from the provisions of Sec. 228.

(ii) The Branch Office of a Company may be exempted by the Central Government from the provisions of Sec. 228 on certain grounds as specified under Rule 4 of the Companies (*Branch Audit Exemption*) Rules, 1961, when application for such exemption is made to, and proper inquiry has been conducted by, the said Government.

N.B. In all cases of exemption, it should be clearly stated in the Audit Report that the requirements of Sec. 228 do not apply to the Branch Office under Audit (reasons to be adduced).

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* By *quantum of activity* should be meant 'the aggregate value of goods or articles produced, manufactured, processed or sold and of services rendered' *or* 'the amount of expenditure, revenue or capital, incurred by a Branch Office of the Company during a financial year', whichever is higher. Basis of calculation of 'average quantum of activity' has been specified in the Rules.

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